Supreme Court, U.S.
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No. (1)

IN THE

Supreme Court of the United States

JOHN J. MOORES, CHARLES E. NOELL, III, NORRIS VAN DEN BERG, CHRISTOPHER A. COLE, AND JMI SERVICES, INC.,
Petitioners,

v.

ROBERT C. FRIESE,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of California

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Whether, with respect to a claim of breach of official duty to a corporation, the Commerce Clause permits a State to substitute its own substantive law for that of the State of incorporation.

Whether the Due Process Clause permits the directors and officers of a corporation incorporated in one State to be sued under the substantive law of another State for alleged breach of official duty to the corporation.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 29.6, Petitioner JMI Services, Inc. states that it has no parent corporation and that no publicly held company owns 10% or more of its stock.

LIST OF PARTIES

Pursuant to Rule 14.1(b), Petitioners state that the following were parties in the California Court of Appeal proceedings below, in addition to those named in the caption:

Rodney Dammeyer
Stephen P. Gardner
Matthew C. Gless
Frederic B. Luddy
Richard T. Nelson
Thomas G. Watrous

In the California Superior Court below, the following were also parties:

Richard A. Hosley II
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PETITION FOR A WRIT OF CERTIORARI

Petitioners John J. Moores, Charles E. Noell, III, Norris van den Berg, Christopher A. Cole, and JMI Services, Inc. ("Petitioners") respectfully petition for a writ of certiorari to review the judgment of the California Court of Appeal, Fourth District, Division One ("Court of Appeal").

OPINIONS BELOW

The order of the Supreme Court of California denying review of the Court of Appeal's opinion (Pet. App. 1a-2a) is unreported. The opinion of the Court of Appeal (Pet. App. 3a-26a) is reported at 36 Cal. Rptr. 3d 558 (Cal. Ct. App. 2005). The decision of the Superior Court of California, San Diego County (Pet. App. 27a-31a) is unreported.

JURISDICTION

The California Supreme Court denied Petitioners' petition for review on March 15, 2006. This Court has jurisdiction under 28 U.S.C. § 1257. Pursuant to Rule 29.4(c), Petitioner certifies that 28 U.S.C. § 2403(b) may apply and that this Petition has been served upon the Attorney General of California.

STATUTES INVOLVED

Sections 2116, 25402, and 25502.5 of the California Corporations Code are reprinted in the appendix to this petition (Pet. App. 32a-33a).

INTRODUCTION AND SUMMARY

This case arises from California's latest effort to assert nationwide regulatory authority over the internal affairs of a corporation incorporated in another State. This case involves no claim by an aggrieved investor in California, no claim by a California government official alleging injury to California markets, and no claim by a California corporation. Rather this case involves a claim by a *Delaware* corporation against its own directors and officers, alleging that they improperly traded stock based on material nonpublic information. This claim is made under California law, subject to California penalties, whether or not Delaware law would recognize such claims or provide similar penalties.

Such a claim by a corporation against its own directors and officers is a classic matter of that corporation's internal affairs. Any claim by a corporation alleging insider trading by its own directors and officers can arise only from a breach of fiduciary duty—specifically, the misuse of corporate information gained in an official capacity. Like any other matter of a corporation's internal affairs, a breach of fiduciary duty to a corporation by that corporation's own directors and officers is a matter that has long been governed solely by the law of the State of incorporation. The orderly conduct of business in the interstate marketplace has gained notable stability and certainty from this principle, often called the

"internal affairs doctrine." The decision below abrogates this venerable principle, and holds that California has the open-ended authority to apply its own law to the internal affairs of foreign corporations whenever, in its view, the "interest of justice" requires.

This ruling raises significant federal constitutional issues that warrant this Court's review. Both the Commerce Clause and the Due Process Clause restrain one State from intruding into the internal affairs of a corporation that has chosen to incorporate in another State. The Commerce Clause, by negative implication, limits the power of a State to regulate commerce outside its borders. A State has no legitimate interest under the Commerce Clause in regulating the internal affairs of an out-of-state corporation. Nor may a State burden interstate commerce by subjecting a corporation's internal governance to inconsistent regulation across state lines.

The Due Process Clause entitles the directors and officers of a corporation to have advance notice of liability they might suffer for breach of fiduciary duty. In violation of that principle, the decision below potentially subjects officers and directors of a Delaware corporation to differing liability to the corporation in any of 49 States other than Delaware, destroying the expectations they had when they agreed to serve the corporation under Delaware law. Compounding the problem, the decision below held that the internal affairs doctrine may be abrogated whenever "the interest of justice" requires. Such a principle is far too vague and open-ended to give the fair warning that due process requires.

The decision below not only sweeps aside these fundamental constitutional principles; it brings the California courts into severe tension with the Delaware Supreme Court. That court recently invalidated an effort by California to interfere with the internal affairs of Delaware corporations. Under California Corporations Code Section 2115, California purported to impose California shareholder voting rules upon

out-of-state corporations with a majority of shares held or business conducted in California. Holding that "application of the internal affairs doctrine is mandated by constitutional principles," *VantagePoint Venture Partners 1996* v. *Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005), the Delaware Supreme Court invalidated this "quasi-California corporation" provision as applied to a Delaware corporation, *see id.* at 1115-16.

In this case, by contrast, the California courts have upheld a California law that intrudes at least as seriously into a Delaware corporation's internal affairs. At issue here is California Corporations Code Section 25502.5. As authoritatively construed by the state courts below, this statute permits a Delaware corporation to sue its own officers and directors, subject to California shareholder demand and board voting rules, for breach of internal duty to the corporation—regardless of what Delaware law might provide. This Court's intervention is warranted to resolve this deep conflict between the principles adopted by the California and Delaware state courts.

Without review by this Court, the decision below threatens serious consequences to the business community and the orderly operations of the national marketplace. The internal affairs doctrine enables corporations and their officers and directors to choose a State of incorporation based on its corporate laws and then to rely upon those laws in performing their fiduciary duties. If the decision below is allowed to stand, corporate directors and officers will be subject to different pleading standards, different standards of proof, different elements, different affirmative defenses and different damages for insider trading claims in every State. Review by this Court is necessary to prevent the uncertainty and confusion engendered by the decision below.

STATEMENT OF THE CASE

1. California's Statutory Scheme.

California's insider trading statute, enacted as part of the Corporate Securities Law of 1968, forbids an "officer, director or controlling person of an issuer" from "purchas[ing] or sell[ing] any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public." Cal. Corp. Code § 25402. Like other States, California provides aggrieved buyers or sellers a civil remedy for violation of this provision. Cal. Corp. Code § 25502. It also permits the state government to sue for violation of this provision. Cal. Corp. Code §§ 25400-25404, 25530.

This case, however, is not such a suit by California investors or government officials. The California statute at issue here—Cal. Corp. Code § 25502.5—authorizes *the corporation itself* to bring insider trading suits against its own officers and directors. Enacted in 1988 as an amendment to the Corporations Code, Section 25502.5(a) provides that "[a]ny person other than the issuer who violates Section 25402 shall be liable to the issuer of the security purchased or sold in violation of Section 25402 for damages in an amount up to three times" the difference between the value of the stock with and without public knowledge of the inside information. Section 25502.5(c) goes on to set forth specific voting and quorum rules governing shareholder demands that the board consider such insider trading allegations, as well as standards of "good faith" that apply to such demands.

Section 25502.5 is unique; "no other state presently has a statutory provision making a person using inside information liable *to the issuer* of that security." Don Berger, *Issuer Recovery of Insider Trading Profits Under Section 25502.5 of the California Corporation Code*, 21 PAC. L.J. 221, 226

(1989-1990) (emphasis added). And Section 25502.5 is uniquely punitive in providing a treble damages remedy; no other State provides such a disproportionate private remedy for alleged insider trading.[1]

2. The Origins of This Case.

Peregrine Systems is a manufacturer of computer software for businesses that was reincorporated in Delaware in 1994 and headquartered in San Diego, California until December 2005. Peregrine's directors included Petitioners John Moores, Charles Noell, Norris van den Berg, and Christopher Cole.

Peregrine's Articles of Incorporation provided at all relevant times that rights and liabilities pertaining to corporate governance matters would be controlled by Delaware law and that Delaware law would define the scope of its directors' liability to the corporation.[2] Peregrine also invoked Delaware

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[1] Federal law likewise is nowhere near as sweeping as California's. Under the closest federal analogues to section 25402—section 10(b) of the Securities Exchange Act and SEC Rule 10b-5—corporations may *not* sue their officers or directors for insider trading involving third parties (much less sue them for treble damages) because the federal cause of action requires proof of reliance by, and actual harm to, the plaintiff. *See Basic Inc.* v. *Levinson*, 485 U.S. 224, 243 (1988) ("We agree that reliance is an element of a Rule 10b-5 cause of action . . . [because it] provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."); *see also Reliance Elec. Co.* v. *Emerson Elec. Co.*, 404 U.S. 418, 422 (1972) (describing section 16(b) of the Act, 15 U.S.C. § 78p(b), which requires officers and directors to disgorge profits made on the sale of securities held for less than six months, as "the only method Congress deemed effective to curb the evils of insider trading").

[2] *See* Peregrine's Form S-1/A, filed March 17, 1997, at 46, *available at* http://www.sec.gov/Archives/edgar/data/1031107/0000912057-97-008972.txt ("The Company has adopted provisions in its Amended and Restated Certificate of Incorporation that eliminate to the fullest extent permissible under Delaware law the liability of its directors to the Company for monetary damages.").

law when it induced its directors to join and to continue to serve on its board.[3]

In May 2002, Peregrine announced that it had overstated earnings in past years as a result of accounting irregularities, and the company's share price fell sharply. Four months later, Peregrine initiated reorganization proceedings in the United States Bankruptcy Court for the District of Delaware. Although Peregrine's internal investigation of the accounting irregularities expressly absolved Petitioners and the other outside directors of any wrongdoing,[4] some shareholders brought federal class action suits against Peregrine and its outside directors under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5, alleging that there had been trading on inside information before Peregrine disclosed its accounting irregularities to the public. In November 2003, the federal district court dismissed all 10b-5 claims against the directors for failure to state a claim. *In re Peregrine Sys., Inc., Sec. Litig.*, No. 02 CV 870-J(RBB) (S.D. Cal. Nov. 23, 2003).

Three months later, in February 2004, Robert C. Friese, the trustee of a Litigation Trust established in Peregrine's bankruptcy and controlled by the federal class action plaintiffs, filed claims assigned to the Litigation Trust by Peregrine in

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[3] *See* Form of Indemnification Agreement, Exhibit 10.7 to Peregrine's Form S-1, filed February 10, 1997, *available at* http://www.sec.gov/Archives/edgar/data/1031107/0000912057-97-003853.txt.

[4] *See* Latham & Watkins Report of Investigation, filed August 9, 2004 in San Diego Superior Court Case No. GIC 788659, at 116 ("There is no evidence that any Outside Director had knowledge of unlawful conduct or serious accounting irregularities before KPMG requested a meeting with the Audit Committee outside the presence of management in April 2002 . . . . Even with the benefit of hindsight, there is no basis to assign blame to the Outside Directors for Peregrine's accounting or disclosure problems.").

California state court against Petitioners and other former Peregrine directors and officers. Among other causes of action, the Litigation Trust (hereinafter "Peregrine") alleged that the Petitioners were liable to the corporation under California Corporations Code § 25502.5. It is undisputed that the only claims asserted in this state action were Peregrine's own claims against its former directors and officers, which Peregrine chose to pursue under California rather than Delaware law.[5]

3. The Proceedings Below.

Petitioners and the other defendants moved to dismiss the state lawsuit, including Peregrine's Section 25502.5 claims, arguing that Delaware law, not California law, must be applied to any insider trading claim by Peregrine against its own directors and officers. The trial court agreed, dismissing the suit on the grounds that "Delaware law governs the relationship between Peregrine and its directors and/or officers" and that plaintiffs had claimed "violations of [California] statutes this Court finds to be not applicable." Pet. App. 29a.

The California Court of Appeal, however, granted Peregrine's petition for a peremptory writ of mandate and vacated the trial court's dismissal in a decision filed December 2, 2005 (Pet. App. 5a-26a), and amended December 29, 2005 (Pet. App. 4a), and January 24, 2006 (Pet. App. 3a). The Court of Appeal construed Section 25502.5, for the first time since its enactment, as extending beyond California corporations and permitting treble-damage insider trading claims

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[5] It is unclear whether Delaware law currently enables a corporation to sue officers and directors for insider trading at all, but if such a claim were permitted, it would require proof of well-defined elements and would not result in any punitive treble damage remedy. *See In re Oracle Corp.*, 867 A.2d 904, 926-34 (Del. Ch. 2004), *aff'd sub nom. In re Oracle Corp. Derivative Litig.*, 872 A.2d 960 (Del. 2005).

even by out-of-state corporations against their own directors and officers. (*See* Pet. App. 24a).

The Court of Appeal rejected the argument that Peregrine's insider trading claims against its own directors and officers are matters of internal affairs subject solely to Delaware law. First, the court noted that Section 25502.5 is "part of California's corporate securities regulation scheme" (Pet. App. 26a), and sought to analogize it to state blue-sky laws protecting California investors (Pet. App. 12a-15a, 21a-23a), even though this case involves no claim by any investor who purchased or sold securities.

Second, the court below held that California may make whatever exceptions to the internal affairs doctrine it chooses "'in the interest of justice.'" (Pet. App. 22a (quoting 9 WITKIN, SUMMARY OF CAL. LAW, CORPORATIONS, § 239 at 1006 (10th ed. 2005))). The court below accepted that Section 25502.5 regulates the internal relationship between a corporation and its own directors and officers, but held that it is "not . . . *merely* a device for enforcing directors' and officers' fiduciary duties." (Pet. App. 25a (emphasis added)). In the view of the court below, Section 25502.5 also serves as a "means of punishing what is perceived by the public as immoral conduct." (Pet. App. 25a). It thus concluded that the internal affairs doctrine may be abrogated and an out-of-state corporation deputized to pursue California's own public policy interests: "'the absence of monetary injury to the issuer of the traded security is less important than the *deterrent* of insider trading.'" (Pet. App. 19a (quoting Berger, *supra*, at 226)).

The Court of Appeal ignored Petitioners' arguments, preserved below (*see* Pet. App. 34a-35a) and presented at length in their appellate briefs (*see* Pet. App. 36a-48a), that the dormant Commerce Clause and Due Process Clause forbid such an abrogation of the internal affairs doctrine.

Over the dissents of two Justices, the California Supreme Court denied the officers' and directors' petition for review (Pet. App. 1a), which again raised both Commerce Clause and Due Process Clause objections (Pet. App. 49a-52a).

The decision of the intermediate appellate court below thus represents an authoritative construction of Section 25502.5 as enabling an out-of-state corporation to pursue a cause of action against its own directors and officers for breach of official duty to the corporation.

REASONS FOR GRANTING THE PETITION

This Court should grant certiorari to resolve the severe tension between decisions of the Delaware and California courts concerning the scope of California's power, consistent with the federal Constitution, to regulate the internal affairs of a Delaware corporation. The decision below poses a significant threat to the orderly conduct of corporate business between the Nation's most populous State and its leading State of incorporation. And the decision below provides a good vehicle for resolving this conflict, as it presents a clean question of law that requires no further state-law development: whether the Commerce Clause and the Due Process Clause permit California to interpret its corporations code to abrogate, in "the interest of justice," the longstanding rule that an out-of-state corporation's internal affairs are to be determined solely by the law of the State of incorporation.

Contrary to the decision below, which wholly ignored Petitioners' extensively briefed federal constitutional arguments, the internal affairs doctrine is a federal constitutional requirement, not a discretionary choice-of-law principle that States may disregard whenever they conclude that "the interest of justice" so warrants. As the Delaware Supreme Court has reiterated, both the Commerce Clause and the Due Process Clause bar a State from reaching across state lines to tell an out-of-state corporation how to order relationships

among the corporation and its directors, officers and shareholders. Just as California may not deem a Delaware corporation with a certain volume of business in California a "quasi-California corporation" subject to California corporate governance law, California may not deputize a Delaware corporation to pursue California's own idiosyncratic state-law objectives by suing its own directors and officers for breach of official duty.

Certiorari is warranted as well to limit the disruptive effects of the decision below upon the business community. The California courts have opened the door to a conflicting patchwork of claims concerning directors' and officers' fiduciary obligations to the corporations they serve. Under the decision below, a Delaware corporate director or officer might be subject to one pleading standard, standard of proof, and set of elements, affirmative defenses and damages in Delaware and another in California for the same underlying conduct. Such potentially conflicting liability unsettles the long-settled order that the internal affairs doctrine has brought to the conduct of interstate business.

I. THE DECISION OF THE CALIFORNIA COURTS BELOW CONFLICTS WITH DECISIONS OF THE DELAWARE SUPREME COURT HOLDING THAT THE FEDERAL CONSTITUTION BARS CALIFORNIA FROM REGULATING THE INTERNAL AFFAIRS OF DELAWARE CORPORATIONS

As the Delaware Supreme Court has observed, "the conflicts practice of both state and federal courts has consistently been to apply the law of the state of incorporation to the entire gamut of internal corporate affairs." *VantagePoint Venture Partners 1996* v. *Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005) (internal quotation marks omitted). As that court earlier explained: "Corporations and individuals alike enter into contracts, commit torts, and deal in personal and real

property. . . . The internal affairs doctrine . . . governs the choice of law determinations involving matters *peculiar* to corporations, that is, those activities concerning the relationships *inter se* of the corporation, its directors, officers and shareholders." *McDermott Inc.* v. *Lewis*, 531 A.2d 206, 214-15 (Del. 1987) (citation omitted). And as that court likewise has repeatedly stated, "application of the internal affairs doctrine is not merely a principle of conflicts law," but "also one of serious constitutional proportions—under due process, the commerce clause and the full faith and credit clause[.]" *Id.* at 216.

Most recently, the Delaware Supreme Court restated these principles as follows:

> Pursuant to the Fourteenth Amendment Due Process Clause, directors and officers of corporations have a significant right . . . to know what law will be applied to their actions and stockholders . . . have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs. Under the Commerce Clause, a state has no interest in regulating the internal affairs of foreign corporations. Therefore, this Court has held that an application of the internal affairs doctrine is mandated by constitutional principles, except in the rarest situations, *e.g.*, when the law of the state of incorporation is inconsistent with a national policy on foreign or interstate commerce.

VantagePoint, 871 A.2d at 1113 (footnotes and internal quotation marks omitted).[6]

Following these federal constitutional principles, the Delaware Supreme Court in *VantagePoint* invalidated a provision of the California Corporations Code that purported to apply

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[6] The latter exception is inapplicable here; there is no claim here that Delaware corporate law is in any way inconsistent with national policy. *See supra* note 1.

California's shareholder class voting rules to Delaware corporations that do significant business in California. *See* Cal. Corp. Code § 2115. Specifically, the California Corporations Code provided that a merger had to be approved by each shareholder class voting separately, whereas the Delaware General Corporation Law provided for approval by outstanding shares of all classes voting together on an as-converted basis. The Delaware Supreme Court held that the Delaware shareholder class voting rules must apply to a Delaware corporation regardless of the volume of business it does in California. It thus rejected the notion that California could project its views of proper corporate governance structure into the internal affairs of a Delaware corporation.

Although the decision below involves a different provision of the California Corporations Code—one to which the Delaware courts have not directly spoken—it rests on a principle that is directly opposed to the one established in *VantagePoint*. The decision below, contrary to *VantagePoint*, holds that California may indeed intrude into the "relationships *inter se* of [a] corporation, its directors, officers and shareholders" in order to serve its own state law objectives. The court below interpreted Section 25502.5—as the Delaware Supreme Court did Section 2115—as governing a Delaware corporation's internal affairs. The court below simply held—unlike the Delaware Supreme Court with respect to Section 2115—that such intrusion was permissible "in the interest of justice" to further California's own idiosyncratic substantive law objectives.

The decision below thus conflicts with *VantagePoint* with respect to interpretation of the Commerce and Due Process clauses; Delaware reads the federal Constitution to limit California's efforts to regulate the internal affairs of Delaware corporations whereas California does not.

Because certiorari was not sought from *VantagePoint*, the question presented here is before this Court for the first time.

The decision below is a good vehicle for resolving it. The decision below, after denial of review by the California Supreme Court, represents a now-authoritative construction of California law permitting a Delaware corporation to sue its own officers and directors for breach of internal fiduciary duty. For the reasons that follow, this decision should be found unconstitutional.

A. As Delaware Has Correctly Held, Contrary to the Decision Below, the Commerce Clause Bars a State from Regulating the Internal Affairs of an Out-of-State Corporation

The Commerce Clause provides that "[t]he Congress shall have Power . . . [t]o regulate Commerce . . . among the several States." U.S. Const., art. I, § 8, cl. 3. It is well settled that, in addition to vesting this specific authority in Congress, the Commerce Clause also has a negative, or "dormant," aspect that "even without implementing legislation by Congress is a limitation upon the power of the States." *Edgar* v. *MITE Corp.*, 457 U.S. 624, 640 (1982) (plurality opinion) (quoting *Great Atl. & Pac. Tea Co.* v. *Cottrell*, 424 U.S. 366, 370-71 (1976)).

Among these limitations is a prohibition on one State's regulation of the internal affairs of a corporation incorporated in another State. "The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders." *Edgar v. MITE*, 457 U.S. at 645. That "one State," this Court has held, is the State of incorporation. *See First Nat'l City Bank* v. *Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983).

The Commerce Clause is violated in three distinct ways when one State interferes in the internal affairs of a corpora-

tion incorporated in another State by altering the law that applies to a corporation's suit against its own directors and officers.

First, and most fundamental, the Commerce Clause bars a State from regulating commerce outside of that State's borders, even if the commerce has effects within that State. In *Southern Pacific Co.* v. *Arizona*, 325 U.S. 761 (1945), for example, the Court struck down on Commerce Clause grounds a state law where the "practical effect of such regulation is to control [conduct] beyond the boundaries of the state." *Id.* at 775. As this Court has noted, the Commerce Clause "limits on a State's power to enact substantive legislation are similar to the limits on the jurisdiction of state courts. In either case, 'any attempt "directly" to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power.'" *Edgar v. MITE*, 457 U.S. at 643 (quoting *Shaffer* v. *Heitner*, 433 U.S. 186, 197 (1977)); *cf. Healy* v. *Beer Institute*, 491 U.S. 324, 337-38 (1989) (invalidating a State's extraterritorial regulation of beer prices). California's effort to provide the rule of decision for claims by a corporation that has incorporated in Delaware under Delaware law against its own directors and officers amounts to such extraterritorial regulation.

Second, although the Commerce Clause permits States to regulate interstate commerce incidentally, "direct regulation is prohibited." *Edgar v. MITE*, 457 U.S. at 640. In *Edgar*, this Court held that an Illinois tender-offer law violated the Commerce Clause because it "directly regulates transactions which take place across state lines, even if wholly outside the State of Illinois," since a tender offer for securities of a publicly held corporation is communicated through means of interstate commerce and the takeover is an interstate transaction. *Id.* at 641. A State law likewise directly burdens interstate commerce when it purports to legislate the remedies

of an out-of-state corporation against its own directors and officers, who may not be California residents, for trading shares on a national exchange with persons who may not be California residents, as long as the offer to trade "originated from California." *See* Cal. Corp. Code § 25008 (defining purchase and sale of a security).

Third, the Commerce Clause bars a State from burdening interstate commerce indirectly "by subjecting activities to inconsistent regulations." *CTS Corp.* v. *Dynamics Corp.*, 481 U.S. 69, 88 (1987). The decision below imposes such a burden by reading California law so as to "create an impermissible risk of inconsistent regulation by different States." *Id.* at 89-90. Nor is such a burden justified by a legitimate local interest. *See Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 142 (1970) (holding that state laws may not indirectly burden interstate commerce unless outweighed by a legitimate local interest). Because States "ha[ve] no interest in regulating the internal affairs of foreign corporations," state laws purporting to do so violate the Commerce Clause. *Edgar v. MITE*, 457 U.S. at 645-46.

The internal affairs doctrine serves the Nation's keen interest, expressed in the Commerce Clause, in avoiding a patchwork of inconsistent state regulations under which corporate actors cross state lines at their peril. Our "beneficial free market system depends at its core upon the fact that a corporation—except in the rarest situations—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation." *CTS Corp.*, 481 U.S. at 90. Such uniform treatment is necessary to meet "the need for certainty and predictability of result while generally protecting the justified expectations of

parties with interests in the corporation." *First Nat'l City Bank*, 462 U.S. at 621.[7]

Like the Delaware Supreme Court, a number of federal circuits have also recognized that, under this Court's Commerce Clause precedents, the internal affairs doctrine prohibits States from regulating the internal affairs of out-of-state corporations. For example, Judge Easterbrook, writing for the Seventh Circuit, has explained that under *CTS Corp.* and *Edgar v. MITE*, "the liability of corporate investors and directors for intra-corporate affairs almost invariably depends on the law of the place of incorporation." *Nagy* v. *Riblet Prods. Corp.*, 79 F.3d 572, 576 (7th Cir. 1996) (certifying question to Delaware Supreme Court regarding scope of fiduciary duty majority shareholders have to minority shareholders). That conclusion, he added, is necessary for the sound administration of U.S. corporate law: "A single rule for each corporation's internal affairs reduces uncertainty and the prospect of inconsistent obligations; it also enables the corporate venturers to adjust the many variables of corporate life (including the contractual promises made to CEOs), confident that they can predict the legal effect of these choices." *Id.*; *see Batchelder* v. *Kawamoto*, 147 F.3d 915,

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[7] *See also Kamen* v. *Kemper Fin. Servs., Inc.*, 500 U.S. 90, 106 (1991) ("'Uniform treatment of directors, officers and shareholders is an important objective which can only be attained by having the rights and liabilities of those persons with respect to the corporation governed by a single law.'" (citing RESTATEMENT (SECOND) CONFLICT OF LAWS § 302)); *Cort* v. *Ash*, 422 U.S. 66, 84 (1975) ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."); *cf. Rogers* v. *Guaranty Trust Co.*, 288 U.S. 123, 130 (1933) ("It has long been settled doctrine that a court—state or federal—sitting in one state will, as a general rule, decline to interfere with, or control by injunction or otherwise, the management of the . . . corporation organized under the laws of another state.").

920 (9th Cir. 1998) (citing *CTS Corp.* and holding that double derivative claims must be evaluated under Japanese law); *Hyde Park Partners, L.P.* v. *Connolly*, 839 F.2d 837, 843-48 (1st Cir. 1988) (discussing *CTS Corp.* and *Edgar v. MITE*).

In conflict with all of these decisions, the Court of Appeal held below that, whenever a California court perceives a need to vindicate some California state law interest, it "may, in the interest of justice, take jurisdiction over internal affairs and apply the local law." Pet. App. 22a (internal quotation marks omitted). The court cited no basis in constitutional law for that sweeping and open-ended abrogation of the internal affairs doctrine, and there is none.

The court sought to justify this holding on two grounds, both untenable. First, it suggested that, because of its location in the California Corporations Code, Section 25502.5 must be analogous to state "blue-sky laws." Pet. App. 22a, 24a-25a. Blue-sky laws, however, govern the sale of securities to investors in securities markets—matters entirely external to the corporation.[8] Section 25502.5, by contrast, is not a blue-sky law, but a regulation of a corporation's *internal* affairs, relating to the liability of corporate officers and directors to the corporation itself.[9] Section 25502.5 cannot be a

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[8] *See Fulton Corp.* v. *Faulkner*, 516 U.S. 325, 336 (1996) (characterizing blue-sky laws enacted in "most States" as "prescrib[ing] who may sell securities . . . , the procedures that must be followed to do so, and the fees imposed for the privilege"); *see also Edgar v. MITE*, 457 U.S. at 641 (explaining that basis for prior cases upholding constitutionality of blue-sky laws was that those laws "only regulated transactions occurring within the regulating States").

[9] *See* RESTATEMENT (SECOND) CONFLICT OF LAWS § 309 & cmt. a (noting that, as a general rule, "[t]he local law of the state of incorporation will be applied to determine the existence and extent of *a director's or officer's liability to the corporation*, its creditors and shareholders," including "[l]iability . . . for such matters as the *fraudulent mismanagement* of the corporation's affairs" (emphasis added)); *In re Sagent Tech., Inc., Derivative Litig.*, 278 F. Supp. 2d 1079, 1092 (N.D. Cal. 2003) (holding,

blue-sky law merely because of its placement in the state code. Under that reasoning, California could enact any law governing the fiduciary duties of directors and officers of an out-of state-corporation so long as it included it in the securities section of the Corporations Code. Nor can it be a blue-sky law merely because it involves securities, since any breach of fiduciary duty might affect the value of a corporation's securities in the securities market. While the Commerce Clause is not offended when a State sets forth blue-sky laws for the marketing of securities by an out-of-state corporation within its borders, it is offended when a State reaches across its borders to intercede in the relationship between an out-of-state corporation and its own directors and officers.

Second, the court below suggested that California's zealous pursuit of insider trading can somehow trump the national interest in maintaining a single source of law to govern the relationship between a corporation and its directors. *See* Pet. App. 25a-26a. But state law policies may not trump federal constitutional law principles, and States "ha[ve] no interest in regulating the internal affairs of foreign corporations" in any event. *Edgar v. MITE*, 457 U.S. at 645-46.

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contrary to the decision below, that an insider trading claim under California law must fail under the internal affairs doctrine because "there *is* an 'official duty' at issue," namely, "the fiduciary duty owed by officers and directors of a corporation to that corporation and its shareholders"); *Diamond* v. *Oreamuno*, 248 N.E.2d 910, 913 (N.Y. 1969) (grounding a corporation's right to sue its directors for insider trading in the fiduciary duty owed by the directors to the corporation).

If there remained any doubt that Section 25502.5 intrudes directly into the internal corporate affairs of out-of-stock corporations, it is resolved by considering subsection (c) of that provision. Section 25502.5 (c) requires every corporation's board of directors to consider, under California-law standards of "good faith," any insider trading allegation by "any shareholder," and purports to establish quorum and voting requirements with respect to such allegations. Cal. Corp. Code § 25502.5(c) (Pet. App. 33a).

California is of course free to pursue its unusually aggressive campaign against insider trading through any number of other mechanisms, including those already included in its Corporations Code. *See* Cal. Corp. Code §§ 25500-25502, 25504 (allowing insider trading claims by California investors claiming injury); Cal. Corp. Code §§ 25400-25404, 25530 (allowing the State Commissioner to bring enforcement actions against insider trading in California); *see* Cal. Corp. Code §§ 25540-25542 (criminal provisions against insider trading). What is at issue here is whether California may abrogate the internal affairs doctrine by permitting an out-of-state corporation to sue its own directors and officers for conduct in their official capacities in order to promote California's "broad public interests." This abrogation of the internal affairs doctrine should be invalidated under the dormant Commerce Clause.

B. As Delaware Has Correctly Held, Contrary to the Decision Below, Due Process Entitles Directors and Officers of a Delaware Corporation to Rely upon the Expectation that Their Relationship to the Delaware Corporation Will Be Governed by Delaware, Not California, Law

In proper keeping with this Court's precedents, the Delaware Supreme Court has held that the internal affairs doctrine is rooted in due process principles as well as in principles of federalism. "[D]irectors and officers have a significant right, under the fourteenth amendment's due process clause, to know what law will be applied to their actions," and shareholders "also have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs." *McDermott Inc.*, 531 A.2d at 217.

Throughout the modern corporate governance era, directors and officers have undertaken fiduciary duties to the corporations they serve under the law of the State of incorporation—

not under a shifting patchwork of other States' laws. Assured by Peregrine that Delaware law would govern their relationship, the Petitioners here undertook their own obligations to Peregrine under the corporate governance laws of the State of Delaware. *See supra* pp. 6-7. They could not possibly have anticipated the novel California liability to which the decision below subjected them. For nearly 20 years, Section 25502.5 has sat on California's statute books without the California courts ever approving its application to an out-of-state corporation until now. The decision below thus violates Petitioners' "significant right, under the fourteenth amendment's due process clause, to know what law will be applied to their actions." *McDermott, Inc.*, 531 A.2d at 216.

The decision below compounds this due process violation by relying upon a standard as undefined and limitless as the "interest of justice" as a basis for abrogating the internal affairs doctrine. Application of a law is invalid if its contours are so vague that "persons of common intelligence must necessarily guess at its meaning and differ as to its application." *Connally* v. *General Constr. Co.*, 269 U.S. 385, 391 (1926). Liability under our system of laws is not supposed to be a matter of guesswork.

If California is free to abrogate the well-settled internal affairs doctrine any time it deems the "interest of justice" to require as much, potential defendants can have no advance warning of the likelihood or scope of their liabilities. Such *ad hoc* imposition of unexpected and potentially massive liability, which might be different and cumulative in any of 49 states, is inconsistent with the rule of law. As three Justices of this Court wrote in the context of punitive civil damages liability, "[r]equiring the application of law, rather than a decisionmaker's caprice, does more than simply provide citizens notice of what actions may subject them to punishment; it also helps to assure the uniform general treatment of similarly situated persons that is the essence of law itself." *BMW*

of North America, Inc. v. *Gore*, 517 U.S. 559, 587 (1996) (Breyer, J., concurring).

II. THE DECISION BELOW UNDERMINES THE CERTAINTY AND PREDICTABILITY THAT THE INTERNAL AFFAIRS DOCTRINE HAS LONG PROVIDED TO INTERSTATE BUSINESS TRANSACTIONS

The decision below is immensely consequential for the business community. "It is . . . an accepted part of the business landscape in this country for States to create corporations, to define their powers, and to define the rights that are acquired by purchasing their shares." *CTS Corp.*, 481 U.S. at 91. As one commentator has noted, the "*lex incorporationis* . . . validates the autonomy of the parties in a subject where the underlying policy of the law is enabling," thereby "facilitat[ing] planning and enhanc[ing] predictability" in the corporate governance setting. P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 98.

Indeed, variations among the corporate law principles of the various States have created a legal marketplace for incorporation, in which each State encourages businesses to incorporate in its jurisdiction. One of the primary enticements a State can offer to businesses in this marketplace is a mature, well-defined corporate law that gives businesses reasonable certainty about the rules that will govern the business's affairs. *Nagy*, 79 F.3d at 576. ("States compete to provide better rules of corporate law, from which entrepreneurs may choose."). Many large American businesses have made decisions about where to incorporate with an eye towards ensuring the predictability in corporate governance that particular States offer. In particular, businesses like Peregrine "incorporate in Delaware in order to take advantage of that state's corporation law, and its judicial expertise concerning corporate governance, rather than to conduct

business there." *Curtis 1000, Inc.* v. *Youngblade*, 878 F. Supp. 1224, 1254 (N.D. Iowa 1995).

If California and other States subject officers and directors of Delaware corporations to liability rules that Delaware does not recognize, they will unsettle the "stable relationships among [corporate] parties involved" that Delaware law seeks to foster. *CTS Corp.*, 481 U.S. at 91. Indeed, because the decision below permits California courts to override the internal affairs doctrine whenever they conclude that doing so would further "the interest of justice," Pet. App. 22a, it opens the door to highly fact-specific disputes in a variety of contexts concerning which law will govern the relationships between foreign corporations and their officers and directors—precisely the type of *ad hoc* choice-of-law determinations that the internal affairs doctrine is designed to prevent. *See VantagePoint*, 871 A.2d at 1115 ("To require a factual determination to decide which of two competing state laws governs the internal affairs of the corporation at any point in time, completely contravenes the importance of stability within inter-corporate relationships that the United States Supreme Court recognized in *CTS*."). This Court's review in this case is warranted to prevent these highly destabilizing effects on interstate business transactions.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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June 12, 2006

APPENDIX

APPENDIX A

Court Of Appeal, Fourth Appellate District,
Division One No. D046348
IN THE SUPREME COURT OF CALIFORNIA

[Filed Apr. 13, 2006]

En Banc

S141028

ROBERT C. FRIESE, as Trustee, etc.,
Petitioner,

v.

SAN DIEGO COUNTY SUPERIOR COURT,
Respondent;

JOHN J. MOORES *et al.*, Real Parties in Interest.

The order filed on March 15, 2006, denying the petition for review, is amended to read, in its entirety:

"Petition for review DENIED.

Kennard and Baxter, JJ., are of the opinion the petition should be granted.

George, C.J., was absent and did not participate."

/s/ Moreno
Acting Chief Justice

APPENDIX B

Court Of Appeal, Fourth Appellate District,
Division One No. D046348
IN THE SUPREME COURT OF CALIFORNIA

[Filed Mar. 15, 2006]

En Banc

S141028

ROBERT C. FRIESE, as Trustee, etc.,
Petitioner,

v.

SAN DIEGO COUNTY SUPERIOR COURT,
Respondent;

JOHN J. MOORES *et al.*, Real Parties in Interest.

Petition for review DENIED.

Kennard and Baxter, JJ., are of the opinion the petition should be granted.

George, C.J., was absent and did not participate.

/s/ Moreno
Acting Chief Justice

APPENDIX C

CERTIFIED FOR PUBLICATION

STATE OF CALIFORNIA
COURT OF APPEAL, FOURTH APPELLATE DISTRICT
DIVISION ONE

[Filed Jan. 24, 2006]

D046348
(San Diego County
Super. Ct. No. GIC788659)

ROBERT C. FRIESE, as Trustee,
Petitioner,

v.

THE SUPERIOR COURT OF SAN DIEGO COUNTY,
Respondent;

JOHN J. MOORES *et al.*, Real Parties in Interest.

[NO CHANGE IN JUDGMENT]

THE COURT:

On its own motion the court modifies the opinion filed December 2, 2005, as modified on December 29, 2005, as follows:

At the last sentence of the last paragraph of DISCUSSION IV, beginning with "The only reported case" and ending with "issued by domestic corporations" (slip opn., pp. 21-22), delete the footnote 7 reference and delete the footnote 7 text.

There is no change in the judgment.

/s/ Benke
BENKE, Acting P.J.

Copies to: All parties

APPENDIX D

CERTIFIED FOR PUBLICATION

STATE OF CALIFORNIA
COURT OF APPEAL, FOURTH APPELLATE DISTRICT
DIVISION ONE

[Filed Dec. 29, 2005]

D046348
(San Diego County
Super. Ct. No. GIC788659)

ROBERT C. FRIESE, as Trustee,
Petitioner,

v.

THE SUPERIOR COURT OF SAN DIEGO COUNTY,
Respondent;

JOHN J. MOORES *et al.*, Real Parties in Interest.

[CHANGE IN JUDGMENT]

THE COURT:

The opinion filed December 2, 2005, is modified as follows:

At the last paragraph of the opinion (disposition, slip opn., p. 25), replace the phrase "enter an order overruling the demurrers to the insider trading claims" with the phrase "conduct further proceedings consistent with the views we have expressed."

The petition for rehearing is denied.

There is a change in the judgment.

/s/ Benke
BENKE, Acting P. J.

Copies to: All parties

APPENDIX E

CERTIFIED FOR PUBLICATION

STATE OF CALIFORNIA
COURT OF APPEAL, FOURTH, APPELLATE DISTRICT
DIVISION ONE

[Filed Dec. 2, 2005]

D046348
(San Diego County
Super. Ct. No. GIC788659)

ROBERT C. FRIESE, as Trustee,
Petitioner,

v.

THE SUPERIOR COURT OF SAN DIEGO COUNTY,
Respondent;

JOHN J. MOORES et al., Real Parties in Interest.

Proceedings in mandate after superior court sustained demurrers without leave to amend. Joan M. Lewis, Judge. Petition granted.

Mazzarella, Dunwoody & Caldarelli, Mark C. Mazzarella and Marisa Janine-Page; Yetter & Warden and R. Paul Yetter for Petitioner Robert C. Friese.

No appearance for Respondent.

Post, Kirby, Noonan & Sweat and David J. Noonan; Niddrie, Fish & Buchanan and David A. Niddrie; Quinn, Emanuel, Urquhart, Oliver & Hedges, John B. Quinn, Kathleen M. Sullivan and Harry A. Olivar, Jr., for Real Parties in Interest John J. Moores and JMI Services, Inc.

Bewley, Lassleben & Miller and Leighton M. Anderson for Real Party in Interest Christopher A. Cole.

Hahn & Adema, Jane Hahn and Alison P. Adema; Goodwin Procter, Christine S. Chung and Brian E. Pastuszenski for Real Parties in Interest Norris Van Den Berg and Charles E. Noell.

Duckor, Spradling & Metzger, Michael Duckor and Robert M. Shaughnessy for Real Party in Interest Rod Dammeyer.

Bergeson, Daniel J. Bergeson, Stephen D. Rockwell, Caroline McIntyre and Derek H. Lim for Real Party in Interest Stephen P. Gardner.

Goodin, MacBride, Squeri, Ritchie & Day, Wayne Travers Lamprey, Anne H. Hartman and Glenn M. Coffin for Real Party in Interest Thomas G. Watrous.

Vance, Blair & Grady and Thomas L. Vance for Real Party in Interest Matthew C. Gless.

McKenna, Long & Aldridge, Robert S. Brewer, Jr., and Christian D. Humphreys for Real Party in Interest Richard T. Nelson.

Paul, Hastings, Janofsky & Walker and Christopher H. McGrath for Real Party in Interest Frederic B. Luddy.

Office of the State Attorney General, Bill Lockyer, Attorney General, Thomas Greene, Chief Assistant Attorney General, Mark J. Breckler Senior Assistant Attorney General, and Jeffrey A. Rich, Deputy Attorney General, Amicus Curiae for Petitioner Attorney General of the State of California.

Leck & Associates and Robert Burns Leck, Amicus Curiae for Respondent California Manufacturers & Technology Association.

Allan S. Zaremberg, Amicus Curiae for Respondent California Chamber of Commerce and California Business Roundtable.

Corporations Code[1] sections 25402 and 25502.5 are part of the Corporate Securities Law of 1968. In general, section 25402 prohibits so-called "insider trading" by the issuer of securities or by any person who is an officer, director or controlling person of an issuer. Until 1988 only purchasers or sellers of stock who could show that they had been harmed by virtue of insider trading had a right of action against violators of section 25402. In 1988 the Legislature added section 25502.5, which allows the issuer or anyone acting in the name of the issuer to recover from an officer, director or controlling person who has violated section 25402 up to three times the amount such a violator earned by virtue of his or her insider trading. Section 25502.5 is a disgorgement statute and the issuer does not need to show that it was harmed by the activities of the inside trader.

Section 25402 governs only securities transactions which occur in this state. Moreover, only issuers who have more than $1 million in assets and more than 500 shareholders may bring an action under section 25502.5. However, aside from those geographic and capitalization requirements, there are no other express limitations on the scope of either statute. In particular, nothing on the face of either statute limits application of the statutes to securities issued by domestic corporations.

Section 2116, which is not a part of the Corporate Securities Law of 1968, provides that a director's liability to a corporation is a matter of internal governance of the corporation and is governed by the laws of the state in which it is incorporated.

Here the plaintiff is the successor in interest to a Delaware corporation, which has its headquarters and principal place of business in California and does substantial business here. The defendants are a group of former officers and directors of the

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[1] All further statutory references are to the Corporations Code unless otherwise indicated.

corporation. The plaintiff alleges the defendants violated section 25402 and are liable under section 25502.5 to the plaintiff for up to three times the amount the defendants earned by way of their insider trading. The defendants argue that because the issuer was a Delaware corporation and Delaware has no statute analogous to section 25502.5, the internal affairs doctrine as codified in section 2116 prevents the defendants from being held liable under section 25502.5. The trial court agreed and sustained the defendants' demurrers to the plaintiff's insider trading causes of action without leave to amend.

We issued an order to show cause on plaintiff's petition for a writ of mandate. For the reasons we set forth below we grant the petition. Unlike the trial court, we do not believe section 2116's provisions concerning internal corporate governance modify or limit any provision of the Corporate Securities Law of 1968, including in particular section 25502.5. Briefly, while we agree that the duties officers and directors owe a corporation are in the first instance defined by the law of the state of incorporation, such duties are not the subject of California's corporate securities laws in general or section 25502.5 in particular. California's corporate securities laws are designed to protect participants in California's securities marketplace and deter unlawful conduct which takes place here. Because a substantial portion of California's marketplace includes transactions involving securities issued by foreign corporations, the corporate securities laws have been consistently applied to such transactions. There is nothing on the face of section 25502.5 or in its history which suggests that the Legislature intended that it have any narrower scope than other parts of the Corporate Securities Law of 1968.

SUMMARY

Plaintiff and petitioner Robert C. Friese (the trustee) is the Successor Trustee of the Peregrine Litigation Trust, which

itself is successor in interest to and acting in the name and right of the Estate of Peregrine Systems, Inc. The defendants and real parties in interest are former directors and former senior management (defendants)[2] of Peregrine Systems, Inc. (Peregrine), a software manufacturer. Peregrine is a publicly traded Delaware corporation and, as we noted, its headquarters and principal place of business are in San Diego.

According to the allegations of the trustee's complaint, the following circumstances support its claims: In 1997, Peregrine issued its initial public offering (IPO) and its stock was valued at $2.75 per share. Before the IPO, Peregrine's revenue derived mostly from direct sales to end customers. After the IPO, the board of directors implemented a plan to increase revenue by expanding indirect sales to intermediaries who would then resell Peregrine's products to consumers.

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[2] John J. Moores served as a director of Peregrine from March 1989 to March 2003 and as Chairman of the Board from March 1990 through July 2000 and from May 2002 through March 2003. Christopher A. Cole served as President and Chief Executive Officer of Peregrine from 1986 to 1989 and as a director from 1980 to March 2003. Charles E. Noell III served as a director from January 1992 to March 2003. Stephen P. Gardner served as Chief Executive Officer, President and a director from April 1998 to May 2002. Matthew C. Gless served as Vice President, Finance, and Chief Accountant from November 1999 to November 2000 and as Chief Financial Officer and a director from November 2002 to May 2002. Richard T. Nelson served as General Counsel, Corporate Secretary, Vice President of Corporate Development, Senior Vice President of IMG Operations, General Manager of the Xanadu division, Acting Chief Executive Officer and a director during various periods from November 1995 to June 2002. Norris van den Berg served as a director from January 1992 to October 2000. Thomas G. Watrous, served as a director from 1999-2003, appointed to Audit Committee in 2001. Douglas S. Powanda served as a Vice President, Worldwide Sales, and Executive Vice President of Worldwide Operations from January 1998 to July 2001. Frederic B. Luddy served as a Vice President, Research and Development and Chief Technology Officer from July 1997 through August 2003. Trusts controlled by real parties were also named as defendants in the complaint filed in superior court.

In addition to its new sales strategy, Peregrine implemented a new accounting technique. Prior to the IPO, Peregrine employed what is known as the "sell-through" accounting method under which Peregrine recorded revenue when a product was sold to an end user. Following the IPO, Peregrine adopted what is known as the "sell-in" accounting method under which revenue is recorded when a product enters the distribution stream. Peregrine's board of directors adopted the "sell-in" method notwithstanding an admonition from its chief financial officer that this was not a preferred method of recording revenue.

In Peregrine's 1999 public announcements and Securities and Exchange Commission (SEC) filings, Peregrine failed to note that it had adopted the "sell-in" method of recording revenue and that without the new accounting method it would not have met earlier revenue expectations. In fact in 1999 Peregrine posted $138.1 million in revenues, a 123 percent increase over 1998.[3] The increase was largely due to the use of the more aggressive "sell-in" accounting method.

Between April 29, 1999, and August 31, 1999, the defendants collectively sold more than 5.2 million Peregrine shares and received approximately $129 million in proceeds from the stock sales.

In 2000 Peregrine posted revenues of $253.3 million, an increase of 83 percent over the previous year, and the price of its common stock reached an all time high of $79.50 per share. As reported revenues soared, the defendants failed to disclose that indirect sales were exceeding the 25 percent maximum set by Peregrine's auditors, that intermediaries were unable to sell inventory Peregrine had already recorded as revenue, that direct sales were exceedingly low, and that

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[3] Peregrine's fiscal year ends March 31. The 1999 report covered revenues from April 1, 1998, to March 31, 1999.

Peregrine was negotiating a merger defendants knew would likely be negatively received by investors.

Between February 7, 2001, and February 28, 2001, defendants sold over 5 million shares of Peregrine common stock and received in excess of $170 million from the sales. Peregrine posted profits of $564.7 million for 2001, an increase of 123 percent over 2000. Defendants again failed to disclose Peregrine's weak direct sales and reliance on indirect sales.

In May 2002, after Peregrine announced an internal investigation into potential accounting irregularities and the resignation of its chief executive officer, the price of Peregrine's stock dropped 87 percent on April 30, 2002, to 89 cents per share. In September 2002 Peregrine initiated bankruptcy proceedings. During these proceedings, Peregrine cancelled its previously issued common stock, costing shareholders about $4 billion in equity. A restatement of its revenue revealed that Peregrine overstated its profits by more than $500 million, or 38 percent, between April 1999 and December 2001.

On February 24, 2004, the trustee filed a complaint in superior court, alleging violations of California insider trading laws,[4] breach of the fiduciary duty of loyalty, breach of the fiduciary duty of care,[5] waste of corporate assets, conspiracy and unjust enrichment. On April 1, 2005, the trial

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[4] Specifically, the trustee alleged real parties in interest violated section 25402 by selling and transferring Peregrine shares while in possession of material, adverse, nonpublic information. The trustee also alleged Moores and Noell violated section 25403, subdivision (a), by controlling and inducing the sale of company stock in violation of the Corporations Code. (§§ 25402, 25403, subd. (a).)

[5] Alleged against real parties in interest and Richard A. Hosley II, William D. Savoy and Rodney F. Dammeyer. Richard A. Hosley II served as a director from 1992 through 2000. William D. Savoy served as a director from June 2000 to November 2002. Rodney F. Dammeyer served as a director from October 2001 through May 2002.

court sustained the defendants' demurrers to the trustee's insider trading violations without leave to amend. The trial court found that section 2116 and the internal affairs doctrine preclude application of section 25502.5 to the securities the defendants sold. The trustee was given leave to amend his remaining causes of action.

On May 3, 2005, the trustee filed a petition for writ of mandate with this court, challenging the trial court's order sustaining the demurrer. We issued an order to show cause.

DISCUSSION

I

Writ Relief

Writ relief is appropriate here because this case raises an important issue of statutory construction which has not yet been confronted by either this court or our Supreme Court. We also note that, although the trustee was given leave to amend some of his causes of action, it would be wasteful to compel him to fully litigate those claims in the trial court before obtaining a definitive ruling on his insider trading claims. Under these circumstances extraordinary relief is appropriate. (See *Barrett v. Superior Court* (1990) 222 Cal. App.3d 1176, 1183.)

II

Application of California Securities Laws to Foreign Corporations

For the last 100 years California's corporate securities laws have been applied to foreign corporations who do business in this state or whose activities in this state have an impact on this state's securities markets. In *Williams v. Gaylord* (1902) 186 U.S. 157 [22 S.Ct. 798] the Supreme Court was asked to consider application of an 1880 California law which governed mining corporations. The 1880 act provided as follows:

"'Sec. 1. It should not be lawful for the directors of any mining corporation to sell, lease, or otherwise dispose of the whole or any part of the mining ground owned or held by such corporation, nor to purchase or obtain in any way additional mining ground, unless such act be ratified by the holders of at least two thirds of the capital stock of such corporation. Such ratification may be either in writing signed and acknowledged by such stockholders or by resolution duly passed at a stockholders' meeting called for that purpose.'" (*Id.* at p. 158). In *Williams v. Gaylord* a West Virginia mining corporation owned mining ground in California. The plaintiff obtained a mortgage on the corporation's mining ground but did not obtain the necessary shareholder consent. The mortgage secured $50,000 in bonds issued by the corporation. Later, the supplier of materials and labor filed and foreclosed on a mechanics' lien on the same property. The holder of the mechanics' lien argued that the mortgage was unenforceable because the corporation's shareholders had not ratified it. The circuit court and Court of Appeals agreed with the holder of the mechanics' lien. On certiorari the Supreme Court affirmed. The court noted that the California Supreme Court had previously held that the 1880 act applied to foreign corporations. The court then rejected the mortgage holder's contention that the statute improperly intruded upon the internal affairs of a foreign corporation. The court stated: "[W]hen a corporation sells or encumbers its property, incurs debts *or gives securities, it does business, and a statute regulating such transactions does not regulate the internal affairs of the corporation. (Williams v. Gaylord, supra,* 186 U.S. at p. 165, italics added).

The scope of California's securities regulation was considered again in *Western Air Lines, Inc. v. Sobieski* (1961) 191 Cal.App.2d 399 (*Sobieski*). In *Sobieski* the management of a Delaware corporation, which had its headquarters and principal place of business in this state, was engaged in a dispute with minority shareholders. In an effort to frustrate the

minority shareholders' ability to elect directors, the management proposed that the corporation amend its Delaware articles of incorporation to eliminate cumulative voting. The California Commissioner of Corporations determined that any solicitation of proxies approving the elimination of cumulative voting was a sale of securities within the meaning of the Corporations Code and would require a permit from the commissioner. Thereafter, the commissioner denied the corporation's application for a permit. By way of a writ of mandate, the corporation challenged the commissioner's assertion of authority over its attempt to amend its articles. The trial court granted the writ and found, among other matters, that the amendment of the articles of incorporation was an internal affair of the corporation and its shareholders. (*Sobieski, supra*, 191 Cal.App.2d at p. 405.) The Court of Appeal reversed. In rejecting application of the internal affairs doctrine, the court stated: "'"It is true that the courts in California cannot control the internal affairs of any foreign corporation. Such matters are to be conducted in pursuance of and in compliance with the provisions of the charter of the foreign corporation, and the laws of the country where it was created; but in the management and method of its business affairs in California with the citizens and residents thereof, *in the sale or disposition or transfer of the shares of stock*, it must conform to the laws of California in relation to such matters, and is bound thereby. . ."'" (*Sobieski, supra*, 191 Cal.App.2d at pp. 409-410.).

More recently, the scope of California's securities laws was considered in *Diamond Multimedia Systems, Inc. v. Superior Court* (1999) 19 Cal.4th 1036 (*Diamond Multimedia*). In *Diamond Multimedia* the defendants in a nationwide class action lawsuit brought under the unlawful market manipulation provisions of sections 25400 and 25500 argued that California could not provide a remedy for shareholders who did not purchase their shares in California. In rejecting this contention the court found that unlike section 25402,

which is expressly limited to intrastate securities transactions, section 25400 is limited only to unlawful manipulative conduct which occurs in this state. The court found that when such unlawful conduct in California harms out-of-state investors, section 25500 provides them with a remedy even if they did not buy or sell securities in this state. (*Diamond Multimedia, supra,* 19 Cal.4th at p. 1065.) In rejecting the defendants' contention that California had no interest in providing nonresident investors with a remedy, the court stated: "California also has a legitimate and compelling interest in preserving a business climate free of fraud and deceptive practices. California business depends on a national investment market to support our industry. The California remedy for market manipulation helps to ensure that the flow of out-of-state capital necessary to the growth of California business will continue. The Court of Appeal rejected a claim similar to that of petitioners and recognized the importance of extending state-created remedies to out-of-state parties harmed by wrongful conduct occurring in California in *Clothesrigger, Inc. v. G.T.E. Corp.* (1987) 191 Cal.App.3d 605. There the plaintiff sought damages for fraud, negligent misrepresentation and unfair business practices in the charges made by defendant for long distance telephone calls. The trial court denied certification of a nationwide class on the ground that a nationwide class was not suitable as California had no interest in providing greater protection to residents of other states than that provided by their home states. The Court of Appeal reversed that order, noting that defendant had identified no interest of any other state that might be affected by extending California's law to the injured nonresidents, and recognizing that 'California may have an important interest in applying its law to punish and deter the alleged wrongful conduct.' [Citation.]" (*Diamond Multimedia, supra*, 19 Cal.4th at pp. 1064-1065, fn. omitted.)

III

Sections 25402, 25502 and 25502.5

"Insider trading—the use of confidential information not available to the trading public to purchase or sell securities—is prohibited under federal law by section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5 adopted by the Securities Commission pursuant to that statutory provision. Such conduct is also prohibited under provisions of the California Corporate Securities Law of 1968.

"The traditional theoretical justification for prohibiting insider trading is based on the notion that allowing persons who have access to non-public information to use it for securities trading will discourage individual investors without access to such information from trading in the securities markets. Thus, even though persistent arguments have been made by some economists that insider trading is good for the trading markets as a whole and should be permitted, the overwhelming reaction in fact has consistently been to regard it as 'unfair' because it destroys the 'level playing field' among participants in the trading markets.

"In recent years, however, the public objections to insider trading have assumed larger dimensions. While at one time governmental prosecution of small-time insider trading might have been regarded by the general public as overzealous, the discovery of persistent, systematic insider trading activities yielding millions of dollars in profit to well-known securities professionals such as Ivan Boesky and Dennis Levine has changed the underlying objection to insider trading to one of basic morality and cultural values. . . As described by one leading writer, 'Congress has begun to see the problem in more fundamental cultural terms as a manifestation of undue greed among the already well-to-do, worthy of legislative intervention if for no other reason than to send a message of censure on behalf of the American people.'" (Berger, "Issuer

Recovery of Insider Trading Profits Under Section 25502.5 of the California Corporation Code" (1989-1990) 21 Pac. Law Journal 221, 223, fns. omitted (Berger).)

By adoption of sections 25402, 25502 and 25502.5 California has supplemented federal regulation of insider trading. Section 25402 provides as follows: "It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information."

Section 25402 was enacted in 1968 as part of the Corporate Securities Law of 1968. The face of the statute does not restrict its application to securities issued by domestic corporations. Rather as noted at the outset, by its terms section 25402 is only limited to securities transactions which occur in this state. This literal reading of section 25402 is consistent with the intention of the drafters of the Corporate Securities Law of 1968. In enacting the Corporate Securities Law of 1968, including section 25402, the drafters "agreed that the basis of jurisdiction and regulation should be the offer or sale of securities in this State and *should not be related to the principal place of business or corporate domicile.*" (Marsh & Volk, Practice Under the Cal. Securities Laws, History of Cal. Law § 1.06[3], 1-54, italics added (Marsh & Volk).)

As part of the Corporate Securities Law of 1968, the Legislature provided in section 25502 a civil remedy for violation of section 25402. Section 25502 states: "Any person

who violates Section 25402 shall be liable to the person who purchases a security from him or sells a security to him, for damages equal to the difference between the price at which such security was purchased or sold and the market value which such security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information, plus interest at the legal rate, unless the defendant proves that the plaintiff knew the information or that the plaintiff would have purchased or sold at the same price even if the information had been revealed to him."

The remedy provided by section 25502 is problematic because private plaintiffs must establish privity between themselves and violators of section 25402. (See Marsh & Volk, *supra*, Civil Liabilities, § 14.04 [5], 14-55.) Indeed, there is no record of any cases being brought under the provisions of sections 25402 and 25502 between 1968 and 1988. (Berger, *supra*, 21 Pac. Law Journal at p. 233.) However, in the 1980's the integrity of the securities markets was threatened by revelations of extensive insider trading. (Berger, *supra*, 21 Pac. Law Journal at pp. 222-224.) In response to these threats Congress enacted the 1984 Insider Trading Sanctions Act (tit. 15, U.S.C. § 78a, c, o, t, u, ff) and the 1988 Insider Trading & Securities Fraud Enforcement Act (tit. 15, U.S.C. § 78a, b, c, κ, o, t, u, kk). As Professor Berger notes, our Legislature also felt a need to address the issue of insider trading. (Berger, *supra*, 21 Pac. Law Journal at p. 224.) Our Legislature's response to the insider trading scandals of the 1980's was enactment in 1988 of section 25502.5.

Section 25502.5 provides in pertinent part: "(a) Any person other than the issuer who violates Section 25402 shall be liable to the issuer of the security purchased or sold in violation of Section 25402 for damages in an amount up to

three times the difference between the price at which the security was purchased or sold and the market value which the security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information and shall be liable to the issuer of the security or to a person who institutes an action under this section in the right of the issuer of the security for reasonable costs and attorney's fees. [¶] . . . [¶]

"(d) This section shall only apply to issuers who have total assets in excess of one million dollars ($1,000,000) and have a class of equity security held of record by 500 or more persons."

Shortly after enactment of section 25502.5 Professor Berger made the following observation: "Except for new section 25502.5 of the California Corporations Code, no other state presently has a statutory provision making a person using inside information liable to the issuer of that security. [¶] . . . . The controversial aspect of such liability is that normally the issuer in whose favor the monetary recovery for insider trading is sought has sustained no monetary damages from the insider's use of confidential information for trading purposes. The enactment in California of section 25502.5 thus seems to be an important legislative decision that the absence of monetary injury to the issuer of the traded security is less important than the *deterrent* of insider trading by superimposing issuer-directed profit disgorgement to the already existing liability towards the person whose securities the insider purchased or towards the person to whom the insider sold." (Berger, *supra*, 21 Pac. Law Journal at p. 226, fn. omitted, italics added.)

IV

Section 2116 and the Internal Affairs Doctrine

Section 2116 states: "The directors of a foreign corporation transacting intrastate business are liable to the corporation, its shareholders, creditors, receiver, liquidator or trustee in bankruptcy for the making of unauthorized dividends, purchase of shares or distribution of assets or false certificates, reports or public notices or other violation of official duty according to any applicable laws of the state or place of incorporation or organization, whether committed or done in this state or elsewhere. Such liability may be enforced in the courts of this state." As applied to directors' liability, section 2116 is a codification of the "internal affairs doctrine." (See *In re Flashcom, Inc.* (2004) 308 B.R. 485, 490.)

"'The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.' [Citation.] 'States normally look to the State of a business' incorporation for the law that provides the relevant corporate governance general standard of care.' [Citation.]

"'Internal affairs' include 'steps taken in the course of the original incorporation, . . . the adoption of by-laws, the issuance of corporate shares, the holding of directors' and 'shareholders' meetings, . . . *the declaration and payment of dividends* and other distributions, charter amendments, mergers, consolidations, and reorganizations, the reclassification of shares and the purchase and redemption by the corporation of outstanding shares of its own stock.'" [Citations.]

"As stated in the Restatement Second of Conflict of Laws: 'It would be impractical to have matters . . . which involve a

corporation's organic structure or internal administration[] governed by different laws. It would be impractical, for example, if . . . an issuance of shares, *a payment of dividends*, a charter amendment, or a consolidation or reorganization were to be held valid in one state and invalid in another. . . . In the absence of an explicitly applicable local statute to the contrary . . . the local law of the state of incorporation has been applied to determine issues involving corporate acts of the sort [mentioned].' [Citations.]" (*State Farm Mutual Automobile Ins. Co. v. Superior Court* (2003) 114 Cal.App 4th 434, 442-443 (*State Farm*).)

In *State Farm* policyholders in an Illinois mutual insurance company sued the company and alleged that it had failed to properly pay them dividends out of the company's accumulated surplus. The plaintiff policyholders argued that their right to dividends was governed by the substantive law of California. The insurance company argued that under the internal affairs doctrines its dividend obligation was governed by the law of Illinois, where it was incorporated. The court agreed with the insurance company. However, in doing so it took pains to point out that while a corporation's decision to pay dividends was an internal affair, the doctrine had no application to enforcement of a forum state's corporate securities laws. The *State Farm* court, citing *Sobieski*, stated: "This is not to say that, in determining the liability of a foreign corporation, courts must always apply the law of the state of incorporation. In fields like torts, where the typical dispute involves two persons and a single or simple one-shot issue and where the common substantive policy is to spread the loss through compensation and insurance, the preference for forum law and the emphasis on the state interest in forum residents . . . [presents an acceptable application of forum law]. '[Citation.] In the management and method of its business affairs in California with the citizens and residents thereof, in the sale or disposition or transfer of the shares of stock, [a foreign corporation] must conform to the [securities

regulations] of California. . . .' [*Sobieski, supra*, 191 Cal. App.2d at p. 409]." (*State Farm, supra*, 114 Cal.App.4th at p. 447.)

This limitation on the internal affairs doctrine has been adopted by the reporters of Restatement of Conflicts Second. The internal affairs doctrine is set forth in section 309 of the Restatement and provides: "The local law of the state of incorporation will be applied to determine the existence and extent of a director's or officer's liability to the corporation, its creditors and shareholders, except where, with respect to the particular issue, some other state has a more significant relationship under the principles stated in § 6 to the parties and the transaction, in which event the local law of the other state will be applied." In explaining the exception to the general rule, the reporters state: "The rule of this Section will be applied in the absence of an applicable local statute. Many states impose liability by statute upon the directors of foreign corporations for doing, or failing to do, certain acts in the state. *Blue sky laws are typical examples of such statutes.*" (Rest.2d Conflicts of Law, § 309, comment a, italics added.) Professor Witkin has also recognized this limitation on the internal affairs doctrine: "In some situations . . . the local court may, in the interest of justice, take jurisdiction over internal affairs and apply the local law. [Citation.] A typical example is the application of the Corporate Securities [Law of 1968] to protect California residents against fraud in the sale of securities of a foreign corporation." (9 Witkin, Summary of Cal. Law (10th ed.) Corporations, § 239, p. 1006.)

The only reported case which has employed the internal affairs doctrine as codified in section 2116 as a bar to enforcement of California's corporate securities laws is *In re Sagent Technology, Inc. Derivative Litigation* (ND Cal. 2003) 278 F. Supp.2d 1079, 1090 (*Sagent*). In *Sagent* the court dismissed a shareholder's derivative claim brought under section 25402 against corporate directors. It appears from the

court's discussion of the issue that the court was persuaded that the plaintiffs' insider claims were governed by the internal affairs doctrine because of the derivative nature of the claims asserted.[6] The court in *Sagent* did not discuss and apparently did not consider *Williams v. Gaylord*, *Sobieski*, or the other authorities which have consistently found that a state's corporate securities laws are not subject to the internal affairs doctrine. Moreover, the court in *Sagent* did not discuss the history or purpose of California's insider trading prohibitions. For these reasons *Sagent* is not persuasive authority for limitation of those securities laws to securities issued by domestic corporations.[7]

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[6] In distinguishing *Diamond Multimedia* application of California securities laws to out-of-state transactions, the court in *Sagent* stated: "The suit was not a derivative action seeking recovery on behalf of a Delaware corporation, but rather a direct action seeking recovery on behalf of a class of investors for unlawful conduct that had occurred in California. Thus, the reasoning of the California Supreme Court in *Diamond Multimedia* is not directly applicable to the question whether the law of California or the law of Delaware should apply to the insider trading claim. While California, like all states, has an interest in preserving a business climate free of fraud, plaintiffs have not established that California has a more significant relationship to the parties and the transaction than does Delaware. Accordingly, under the provisions of section 309 of the Restatement, the law of Delaware, the state of incorporation, should apply." (*Sagent, supra*, 278 F.Supp. at p. 1091.)

[7] Quite recently, in *Grosset v. Wenaas* (2005) __ Cal.App.4th __ [DAR 12,583 Oct. 20, 2005] (*Grosset*) this court considered the internal affairs doctrine in the context of a derivative lawsuit brought by shareholders who alleged that a Delaware corporation's directors had breached their fiduciary duties to the corporation by, among other matters, allowing the corporation to be sued for insider trading. In addition the plaintiffs alleged that the directors had themselves engaged in insider trading. In response to the derivative action, the corporation appointed a special litigation committee of disinterested board members. The committee retained counsel who investigated the derivative claim. In large part because analogous federal insider trading claims had been dismissed, the committee and the counsel it retained concluded that pursuit of the derivative lawsuit was

V

The Trustee's Section 25502.5 Claims are Not Barred by the Internal Affairs Doctrine

Contrary to the defendants' contention, the internal affairs doctrine as embodied in section 2116 does not prevent the trustee from bringing claims against them under section 25502.5. The defendants appear to accept the proposition that the Legislature's historic and well-established intent to regulate both intrastate conduct and intrastate securities transactions subject securities transactions which take place in this state to California's securities laws even if those securities are issued by foreign corporations. (See *Williams v. Gaylord*, *supra*, 186 U.S. at p. 165; *Sobieski*, *supra*, 191 Cal.App.2d at pp. 409-410; *Diamond Multimedia, supra*, 19 Cal.4th at pp. 1064-1065; Marsh & Volk, *supra*, § 1.06[3],

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not in the corporation's best interest. Accordingly, the committee moved to dismiss the derivative action. The trial court granted the committee's motion.

While the plaintiffs' appeal of the order dismissing the derivative action was pending, the defendant directors moved to dismiss the appeal on the grounds that, by virtue of a merger in which the plaintiffs' shares were repurchased by the corporation, the plaintiffs no longer owned shares in the corporation and under Delaware law no longer had standing to assert a derivative claim against the corporation. In granting the motion we found that the internal affairs doctrine governed the plaintiffs' standing to bring a derivative action. Relying on *State Farm*, we stated: "The issue of whether a stockholder has standing to pursue a derivative action based upon stock ownership is an issue that concerns the relationship between a corporation and its shareholders because it is asking whether a stockholder will be allowed to maintain an action on behalf of the corporation. One definition of an internal affair is the extent of a shareholder's right ""to participate in the administration of the affairs of the corporation . . . .""" (*State Farm, supra*, 114 Cal.App.4th at p. 443.)" (*Grosset v. Wenass*, *supra*, __ Cal.App.4th __ [slip. opn., p. 16].) Our discussion of standing in a derivative lawsuit did not reach the question we are asked to consider here, to wit: is section 25502.5 subject to the internal affairs doctrine as codified in section 2116.

1-54; Rest.2d Conflicts of Law, § 309, comment a; 9 Witkin, Summary of Cal. Law (10th ed.) Corporations, § 239, p. 1006.) The defendants argue however that an issuer's claim under section 25502.5 is *not* a securities regulation. Rather they suggest section 25502.5 gives rise to no more than a derivative breach of fiduciary duty claim which they argue is, for that reason, subject to the internal affairs doctrine. For a number of reasons we do not accept the defendants' characterization of section 25502.5 as merely a device for enforcing directors' and officers' fiduciary duties to shareholders.

The defendants' characterization of section 25502.5 ignores the fact that, like section 25402, it is part of the Corporate Securities Law of 1968. The defendants also ignore the fact that section 25502.5 is a remedy for the substantive insider trading prohibition set forth in section 25402. As we have noted the prohibition on insider trading was adopted as a means of protecting investor confidence in the securities market and more broadly as a means of punishing what is perceived by the public as immoral conduct. (See Berger, *supra*, 21 Pac. Law. Journal, at pp. 222-224, 226.) These public interests are much broader than protection of a corporation's shareholders.

The defendants' assertion that section 25502.5 is limited to protection of shareholder interests also ignores two important aspects of insider trading regulation.

First, as Professor Berger has noted, in general corporations are not damaged when either they or their directors engage in insider trading. (Berger, *supra*, 21 Pac. Law Journal at p. 226.) Thus section 25502.5 cannot be characterized as a means of compensating a corporation for losses it actually experiences when an officer or director engages in insider trading. Secondly, section 25402 prohibits issuers themselves from engaging in insider trading. Thus in compelling an officer or director to disgorge to an issuer profits realized by way of insider trading, section 25502.5 does not provide the issuer

with compensation for any lost opportunity the issuer itself could have lawfully realized. These circumstances undermine the defendants' contention that section 25502.5 is a remedy for any breach of fiduciary duty owed to the corporation. Section 25502.5 does not compensate for any loss a corporation experiences or recover any lawful corporate opportunity.

Reinforcing the public interest served by section 25502.5, as opposed to any narrow shareholder interest, are the treble profits the statute permits an issuer to collect from a violator of section 25402. The deterrence provided by this provision clearly demonstrates that in enacting section 25502.5 the Legislature was very much concerned about discouraging conduct it found destructive to the public interest.

In sum, the history of section 25502.5 and its provisions make it clear that it is very much a part of California's corporate securities regulation scheme and serves broad public interests rather than the more narrow interests of a corporation's shareholders. Given the public and regulatory interests section 25502.5 serves, it is not subject to the internal affairs doctrine as codified in section 2116.

Let a writ of mandate issue directing the trial court to vacate its order sustaining the defendants' demurrers to the trustee's insider trading claims and enter an order overruling the demurrers to the insider trading claims. Costs in the writ proceeding are awarded to the trustee.

CERTIFIED FOR PUBLICATION

/s/ Benke
BENKE, Acting P. J.

WE CONCUR:

/s/ McDonald
McDONALD, J.

/s/ McIntyre
McINTYRE, J.

APPENDIX F

SUPERIOR COURT OF CALIFORNIA,
COUNTY OF SAN DIEGO

Number: GIC788659	**Complaint Date:** 05-15-02	**Hearing Date:** 04/01/05	**Hearing Time:** 08:30AM	**Dept.** 65
Judge/Commissioner: Hon. Joan M. Lewis		**Clerk:** Regina Lindsey-Cooper		
Reporter: Jacqueline Plummer P.O. Box 120128 San Diego, CA 92112-0128		**CSR # :** 7688		
Plaintiff/Petitioner: Peregrine Litigation Trust		**Defendant/Respondent:** Stephen P. Gardner, et al.		
Attorney for Plaintiff/Petitioner: Marisa Janine-Page ☒ P ☐ NP		**Attorney for Defendant/Respondent:** Alison P. Adema (2) ☐ P ☐ NP Christopher H. McGrath (4) ☒ P ☐ NP John S. Quinn (1) ☒ P ☐ NP Kathryn D. Horning (3) ☒ P ☐ NP Robert S. Brewer (5) ☒ P ☐ NP		

* See CMC for all appearances.

1. DEFENDANT DEMURRER
2. DEFENDANT DEMURRER
3. DEFENDANT DEMURRER
4. DEFENDANT DEMURRER
5. DEFENDANT DEMURRER
1. DEFENDANT MTN TO STRIKE
2. DEFENDANT MTN TO STRIKE
3. DEFENDANT JOINDER BY T.G. WATROUS (JOINS IN MOORES DEMURRER)
4. DEFENDANT JOINDER BY S.P. GARDNER (JOINS IN MOORES DEMURRER)
5. DEFENDANT JOINDER BY R. DAMMEYER (JOINS MOORES, SAVOY, NOELL'S DEMURRER)
1. DEFENDANT JOINDER BY C.A. COLE (JOINS IN MOORES DEMURRER)

THIS MATTER HAVING COME BEFORE THE COURT THIS DATE, THE COURT ORDERS:

☐ Prior To Calendar Call	☐ Off-Calendar	☐ Granted ☐ Denied	☐ Bonds ☐ With/ Without Prejudice
☐ Prior To Calendar Call	☐ Cont. To__ In Dept.__ At__		
☐ TRO	☐ Continued	☐ Vacated	
☐ All Previous Orders Remain In Full Force And Effect			
☐ Oral Argument	Tentative Dated: 4-1-05	☒ Confirmed	☒ Modified
☐ Disposes Of Entire Action		☐ Does Not Dispose Of Entire Action	
☐ Prevailing Party To Prepare And File Formal Order Pursuant To CRC 391			
☐ Other			

Preliminarily, the Court notes that throughout the parties' papers counsel referenced, incorporated and joined arguments contained in other filings. This was not helpful to the Court and appears, in certain circumstances, to have been an attempt to circumvent the Court's ruling relative to page limitations. In the future, absent order of Court, this type of incorporation by reference will not be considered.

The following Defendants have filed demurrers to the Amended Consolidated Complaint ("the Complaint") in this action. John J. Moores, individually and as trustee, and JMI Services, Inc.; Charles E. Noell, III, Norris van den Berg and Richard A. Hosley, II; William D. Savoy; Frederic B. Luddy; and Richard Nelson. Joinders have been filed by Defendants Thomas G. Watrous; Stephen P. Gardner; Rod Dammeyer; and Christopher Colde. The Court's ruling relative to the demurrers applies to any party that joined in the demurrers.

After having reviewed and considered all papers submitted, the Court rules as follows.

The demurrers to the first through fifth causes of action are sustained on the basis that Delaware law governs the relationship between Peregrine and its directors and/or officers. It is undisputed that Peregrine was incorporated in the State of Delaware. The Court finds that Calif. Corp. Code Sec. 2116 and the internal affairs doctrine require application of Delaware law. Plaintiff argued that California law should control, relying principally on *Diamond Multimedia Sys. Inc. v. Superior Court* (1999) 19 Cal. 4th 1036. *Diamond Multimedia*, however, concerned different statutes and a different issue than is before this Court and is therefore distinguishable. *See In re Sagent Tech., Inc. Deriv. Litig.*, 278 F. Supp.2d 1079 (N.D. Cal. 2003). Because the first five causes of action of the complaint are for violations of statutes this Court finds to be not applicable, the demurrers to the first through fifth causes of action are sustained without leave to amend.

The demurrers to the sixth cause of action are sustained with 30 days leave to amend for Plaintiff to plead, if possible, facts to satisfy the element of scienter.

Additionally, the Court believes that Plaintiff must be able to plead some damage for this cause of action to proceed. To the extent Plaintiff's damage claim is limited to its "damaged reputation, diminished goodwill, litigation costs, and bankruptcy expenses" as pled at Para. 14 of the Complaint, Plaintiff must plead a casual connection between the demurring Defendants' conduct and this alleged harm.

The director demurrers to the seventh cause of action are sustained. In sustaining the demurrer, the Court finds these claims, as currently pled, are barred by Peregrine's Certificate of Incorporation which eliminated liability for breaches of the duty of care and/or by the business judgment rule. To the extent facts could be pled which would demonstrate an exception to the benefits of the certificate or the business judgment rule, Plaintiff is given 30 days leave to amend to plead such facts.

The demurrers of Defendant Luddy and Nelson to the sixth and seventh causes of action are further sustained with 14 days leave to amend for Plaintiff to plead the factual basis for its claim that these officers owed fiduciary duties under the facts alleged in this case.

The demurrers to the eighth cause of action for corporate waste are sustained with 30 days leave to amend for Plaintiff to plead, if possible, the diversion of corporate assets.

The demurrers to the ninth cause of action for conspiracy are sustained with 30 days leave to amend. In light of the fact that the Court finds the complaint, as currently pled, fails to state any actionable conduct against the demurring Defendants, the conspiracy cause of action would fail.

The demurrers to the tenth causes of action are sustained with 30 days leave to amend for Plaintiff to plead, if possible, that it was harmed as a result of any conduct on the part of these Defendants.

The motions to strike are off calendar as moot in light of the rulings on the demurrers. However, the Court notes that if Plaintiff amends its complaint any basis for tolling a limitations period shall be pled.

In ruling on the demurrers and motions to strike the Court took judicial notice where appropriate under the Evidence Code. Any concerns regarding the scope of judicial notice may be addressed at the time of the hearing.

IT IS SO ORDERED

Dated: 4/1/2005

/s/ Joan M. Lewis
HON. JOAN M. LEWIS
Judge of the Superior Court

APPENDIX G

CALIFORNIA CORPORATIONS CODE

Section 2116

§ 2116. The directors of a foreign corporation transacting intrastate business are liable to the corporation, its shareholders, creditors, receiver, liquidator or trustee in bankruptcy for the making of unauthorized dividends, purchase of shares or distribution of assets or false certificates, reports or public notices or other violation of official duty according to any applicable laws of the state or place of incorporation or organization, whether committed or done in this state or elsewhere. Such liability may be enforced in the courts of this state.

* * * *

Section 25402

§ 25402. It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information.

* * * *

Section 25502.5

§ 25502.5. (a) Any person other than the issuer who violates Section 25402 shall be liable to the issuer of the security purchased or sold in violation of Section 25402 for damages

in an amount up to three times the difference between the price at which the security was purchased or sold and the market value which the security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information and shall be liable to the issuer of the security or to a person who institutes an action under this section in the right of the issuer of the security for reasonable costs and attorney's fees.

(b) The amounts recoverable under this section by the issuer shall be reduced by any amount paid by the defendant in a proceeding brought by the Securities and Exchange Commission with respect to the same transaction or transactions under the federal Insider Trading Sanctions Act of 1984 (15 U.S.C. Secs. 78a, 78c, 78o, 78t, 78u, and 78ff) or any other act regardless of whether the amount was paid pursuant to a judgment or settlement or paid before or after the filing of an action by the plaintiff against the defendant. If a proceeding has been commenced by the Securities and Exchange Commission but has not been finally resolved, the court shall delay entering a judgment for the plaintiff under this section until that proceeding is resolved.

(c) If any shareholder of an issuer alleges to the board that there has been a violation of this section, the board shall be required to consider the allegation in good faith, and if the allegation involves misconduct by any director, that director shall not be entitled to vote on any matter involving the allegation. However, that director may be counted in determining the presence of a quorum at a meeting of the board or a committee of the board.

(d) This section shall only apply to issuers who have total assets in excess of one million dollars ($1,000,000) and have a class of equity security held of record by 500 or more persons.

APPENDIX H

SUPERIOR COURT FOR THE STATE OF CALIFORNIA
COUNTY OF SAN DIEGO

Consolidated Case No.: GIC 788659

PEREGRINE LITIGATION TRUST,
Plaintiff,

v.

JOHN J. MOORES, *et al.*,
Defendants.

Date:	April 1, 2005
Time:	8:30 a.m.
Courtroom:	Department 65
Judge:	Hon. Joan M. Lewis

CORRECTED AMENDED NOTICE OF DEMURRERS AND DEMURRERS OF DEFENDANT JOHN J. MOORES, INDIVIDUALLY AND AS TRUSTEE, AND JMI SERVICES, INC. TO AMENDED CONSOLIDATED COMPLAINT; MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF

[Revised per Court's January 14, 2005 instructions]

[Filed Concurrently Herewith:
(1) Declaration of Sarah J. Cole;
(2) Request for Judicial Notice; and
(3) Notice of Lodging of Non-California Authorities]

* * * *

[FN2] Mr. Moores and JMI Services reserve all other objections to purported claims under Cal. Corp. Code § 25502.5, even if not asserted herein. These include preemption, unconsti-

tutionality of the statute and its duplicative recoveries under the Due Process Clause and the Commerce Clause, and the prohibition on assignment of punitive claims. *See State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 416-18 (2003) (limiting punitive awards); *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987); *McDermott Inc. v. Lewis*, 531 A.2d 206, 217 n.12 (Del. 1987) (*CTS Corp.* makes clear "that the commerce clause mandates that a state apply the internal affairs doctrine"). *See generally* Don Berger, *Issuer Recovery of Insider Trading Profits Under Section 25502.5 of the California Corporations Code*, 21 Pac. L.J. 221, 224 (1990) (raising questions regarding the duplicative recoveries purportedly permitted by § 25502.5); Demurrer of Richard T. Nelson (raising assignment defects).

* * * *

DATED: March 22, 2005

QUINN EMANUEL URQUHART OLIVER & HEDGES, LLP

By /s/ Harry A. Olivar, Jr.
Harry A. Olivar, Jr.
Attorneys for Defendants John J. Moores, Individually and as Trustee, and JMI Services, Inc.

APPENDIX I

IN THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOURTH APPELLATE DISTRICT, DIVISION ONE

Civil Number D046348

PEREGRINE LITIGATION TRUST,
in the name of Peregrine Systems, Inc.,
Petitioner,

v.

SUPERIOR COURT OF CALIFORNIA
FOR THE COUNTY OF SAN DIEGO,
Respondent.

San Diego Superior Court Case No. GIC 788659
April 1, 2005 Order of the Hon. Joan M. Lewis

Return to Order to Show Cause of Real Parties in Interest
John J. Moores, Charles E. Noell, III, Norris van den Berg,
Christopher A. Cole, Thomas G. Watrous, and
JMI Services, Inc.

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* * * *

III. APPLYING SECTION 25502.5 TO A FOREIGN CORPORATION'S CLAIMS AGAINST ITS OWN DIRECTORS AND OFFICERS WOULD VIOLATE THE COMMERCE AND DUE PROCESS CLAUSES OF THE UNITED STATES CONSTITUTION.

The principle of "constitutional avoidance" is well established: a statute should be read in a way that causes it to pass constitutional muster. *See Dyna-Med, Inc. v. Fair Employment & Housing Comm'n*, 43 Cal. 3d 1379, 1387 (1987) ("A statute should be construed whenever possible so as to preserve its constitutionality."). Petitioner's reading of Section 25502.5 does the opposite.

A. An Attempt by California to Regulate Claims by a Foreign Corporation Against Its Own Directors and Officers for Unlawful Trading on a National Market Would Violate the Commerce Clause.

To determine whether a law violates the Commerce Clause, a court determines whether the law directly or indirectly regulates interstate commerce. *See* Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 Law & Contemp. Probs. 161, 185 (1985) (hereinafter "DeMott, *Perspectives*"). A direct regulation of interstate commerce is always prohibited. *Edgar v. MITE Corp.*, 457 U.S. 624, 640 (1982). An indirect regulation is prohibited if the burden on interstate commerce is disproportionate to any legitimate local interests furthered by the regulation. *Id.*; DeMott, *Perspectives*, at 185. The United States Supreme Court has held that the burden on interstate commerce is disproportionate when the regulation "subject[s] activities to inconsistent regulations." *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 88 (1987).

1. *Section 25502.5, as Interpreted by Petitioner, Would Be an Impermissible Direct Regulation of Interstate Commerce.*

Under Petitioner's interpretation of Section 25502.5, California would supply the rule of decision for claims by a foreign corporation against its directors or officers whenever an offer to sell "originates" from California. *See* Petition at 16. That would mean that California law would apply if a director were to make a telephone call while physically present in California to her broker in another state to direct a sale on a national market. California law would also apply if the director were to sign onto the internet while physically present in California to direct a sale on a national market from an online brokerage account. This interpretation of Section 25502.5 would violate the Commerce Clause because it would result in California's direct regulation of interstate commerce.

The United States Supreme Court considered a similar situation in *Edgar*. There, Illinois sought to regulate takeover offers directed at certain target companies operating in Illinois. *Edgar*, 457 U.S. at 626-27. The Supreme Court plurality held that the law directly regulated interstate commerce in violation of the Commerce Clause:

> A tender offer for securities of a publicly held corporation is ordinarily communicated by the use of the mails or other means of interstate commerce to shareholders across the country and abroad. . . . [Defendant] . . . necessarily employed interstate facilities in communicating its offer, which, if accepted, would result in transactions occurring across state lines. These transactions would themselves be interstate commerce. . . . *Indeed, the Illinois law on its face would apply even if not a single [shareholder] were a resident of Illinois* . . . . It is therefore apparent that the Illinois statute is a direct restraint on interstate commerce . . . .

Id. at 641-42 (emphasis added).

For the same reasons that the Illinois statute was a direct regulation of interstate commerce, Section 25502.5, as interpreted by Petitioner, would be also. Under Petitioner's reading, the statute would apply to offers communicated by the use of the telephone, internet, or other means of interstate commerce—and to purchases and sales transactions taking place across state lines. The statute would apply even if the corporation were a foreign corporation with no directors or shareholders who were California residents. A director of a foreign corporation with no California shareholders could be sued by her own corporation under California law merely because she set foot in California and directed a purchase or sale on a national exchange. Not surprisingly, the Commerce Clause prohibits this result. *See id.* at 640.

2. *Section 25502.5, as Interpreted by Petitioner, Is an Impermissible Indirect Regulation of Interstate Commerce.*

As the United States Supreme Court has recognized, a statute that regulates the internal affairs of a corporation is an impermissible indirect regulation of interstate commerce because it does not promote any legitimate local interests: "[A] state 'has no interest in regulating the internal affairs of foreign corporations.'" *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005) (quoting *Edgar*, 457 U.S. at 645-46); *see also CTS Corp.*, 481 U.S. at 93 ("[A state] has no interest in protecting nonresident shareholders *of nonresident corporations*.") (emphasis in original). "[A]pplication of local internal affairs law . . . to a foreign corporation . . . is 'apt to produce inequalities, intolerable confusion, and uncertainty, and intrude into the domain of other states that have a superior claim to regulate the same subject matter.'" *VantagePoint*, 871 A.2d at 1114.

If applied to regulate claims by a foreign corporation against its directors and officers, which involve the internal affairs of the corporation, *see supra* Section I.B, Section

25502.5 would not promote any legitimate local interest. And it would disproportionately burden interstate commerce. An indirect regulation of interstate commerce is disproportionately burdensome when it subjects an activity to inconsistent regulations. *CTS Corp.*, 481 U.S. at 88. As interpreted by Petitioner, Section 25502.5 would subject foreign corporations and their directors and officers to inconsistent regulations in two ways.

First, under Petitioner's interpretation of Section 25502.5, directors and officers could be liable to Peregrine under California law for treble their trading profits merely by trading at a time when they possessed material, non-public information, *i.e.*, *scienter* would not be required. *See* Petition at 8 (arguing that Section 25502.5 allows recovery of treble a director's profits any time the director trades while possessing material, non-public information). This is contrary to Delaware law. *See Guttman v. Huang*, 823 A.2d 492, 505 (Del. Ch. 2003) (holding that Delaware law allows recovery of a director's profits only if he trades because of material, non-public information).

Second, Petitioner's interpretation would require Peregrine to declare any director accused of violating Section 25402 "interested," and hence disqualified from voting on whether the corporation should pursue legal action. *See* Cal. Corp. Code § 25502.5(c) (a director is "interested" and must abstain from voting if he is accused of unlawful trading). This is also contrary to Delaware law. *See Guttman*, 823 A.2d at 502 ("As a matter of course, corporate insiders sell company stock. . . . [I]t is unwise to formulate a common law rule that makes a director 'interested' whenever a derivative plaintiff cursorily alleges that he made sales of company stock in the market at a time when he possessed material, non-public information.").

Petitioner's expansive interpretation of Section 25502.5 would thus subject the internal activities of Peregrine to in-

consistent regulations in violation of the Commerce Clause. It cannot be the law. *See CTS Corp.*, 481 U.S. at 88; *Dyna-Med*, 43 Cal. 3d at 1387.

B. Allowing a Delaware Corporation to Sue Its Directors for Trading Under California Law Would Violate the Due Process Clause.

In inducing Real Parties to serve as directors, Peregrine represented to them that any liability they might have to the corporation would be governed by Delaware law. *See* Ex. 7-E at 285-94. This commitment that claims against the directors would be governed by Delaware law was confirmed by the company in its Certificate of Incorporation, wherein Peregrine expressly invoked and relied upon Delaware law to define the scope of its directors' liability to the corporation:

> The Company has adopted provisions in its Amended and Restated Certificate of Incorporation that eliminate to the fullest extent permissible under Delaware law the liability of its directors to the Company for monetary damages.

Ex. 7-D at 274; Ex. 7-N at 443. Further, the Confirmation Order of the Delaware Bankruptcy Court recognized that any liability the directors may have to Peregrine or the Litigation Trust, its assignee, is to be determined under Delaware law. *See* Ex. 7-F at 314-15, ¶56.

Real Parties and all other persons who accepted invitations to become directors were entitled to rely on the representation that Delaware law would govern their rights and duties with respect to Peregrine. *See Fasciana v. Electronic Data Sys. Corp.*, 829 A.2d 160, 170 (Del. Ch. 2003) ("Without affording . . . protection [on which directors can rely], corporations would find it difficult to retain high-quality directors . . ., especially ones willing to make socially useful decisions that involve economic risk."). Petitioner's effort to renege on Peregrine's prior representations and commitments to its

directors and invoke another state's law that subjects them to punitive damages, if accomplished, would be fundamentally unfair and violate the directors' due process rights under the United States Constitution for two reasons.

First, any decision that frustrates the directors' expectations, created by Peregrine, that any liability to Peregrine would be governed by Delaware law would violate the Due Process Clause. *See Norwest Mortgage, Inc. v. Superior Court*, 72 Cal. App. 4th 214, 227 n.16 (1999) ("Our conclusion that application of California law would offend due process limitations is further supported by [the] observation that '[w]hen considering fairness in this context, an important element is the expectation of the parties. . . . Here, there is no basis to conclude any non-Californian expected California law would govern his claim; instead, the contractual relationship between [defendant] and the borrowers specified the law of place of the encumbered property would govern."). Like the parties in *Norwest Mortgage*, Real Parties here never expected that California law (or the law of any state other than Delaware) would govern claims Peregrine might assert against them for violations of duty. These expectations were reasonable because, for among other reasons, Peregrine repeatedly represented to its directors that Delaware law would apply. *See* Ex. 7-D at 274; Ex. 7-E at 285-294. The only reason that California law is now being invoked is because Petitioner wants to take advantage of the perceived friendliness of California's punitive treble damages provision. Due process considerations prevent it from doing so after the fact. *Norwest Mortgage*, 72 Cal. App. 4th at 227 n.16.

Second, the internal affairs doctrine requires that one state's laws—those of the state of incorporation—govern Peregrine's claims against its directors and officers. *See supra* Section I.B. This is because "[w]ith the existence of multistate and multinational organizations, directors and officers have a significant right . . . to know what law will be

applied to their actions." *State Farm*, 114 Cal. App. 4th at 444. This right is also a constitutional right protected by the Due Process Clause. *See VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005).

If it were constitutionally permissible for another state to apply its local law to a Delaware corporation's claims against its own directors, directors would never know what law would apply to their actions. Well-traveled directors could conceivably be liable to their own corporations under 50 different legal standards imposed by 50 different states, depending upon a factual determination as to where a director's purchase or sale "originated." *See* Petition at 16. "To require a factual determination to decide which of two conflicting state laws governs the internal affairs of a corporation at any point in time, completely contravenes the importance of stability within inter-corporate relationships that the United States Supreme Court recognized" and would violate the directors' due process rights. *VantagePoint*, 871 A.2d at 1113-15. Moreover, directors could simultaneously be liable under the laws of more than one state for the same transaction. For example, one state might contend its law governs sales originating in the state; another might contend its law governs sales executed in the state. The same sale could originate in one state and be executed in another. Petitioner's view of Section 25502.5 cannot be the law. *See Dyna-Med*, 43 Cal. 3d at 1387.

* * * *

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APPENDIX J

IN THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOURTH APPELLATE DISTRICT, DIVISION ONE

Civil Number D046348

PEREGRINE LITIGATION TRUST,
in the name of Peregrine Systems, Inc.,
Petitioner,

v.

SUPERIOR COURT OF CALIFORNIA
FOR THE COUNTY OF SAN DIEGO,
Respondent.

San Diego Superior Court Case No. GIC 788659
April 1, 2005 Order of the Hon. Joan M. Lewis

Petition for Rehearing of Real Parties in Interest
John J. Moores, Charles E. Noell, III, Norris van den Berg,
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* * * *

B. *The Court's Opinion Does Not Address Real Parties' Commerce Clause and Due Process Clause Arguments.*

It is clear that the Court must interpret a statute in "light of the constitutional restrictions upon the power of the legislature." *County of Los Angeles v. Riley* (1936) 6 Cal. 2d 625, 628-29. Where, for example, the subject statute is unconstitutionally overbroad because the enactment is silent as to the scope of its application, it will be presumed that the Legislature intended to limit the statute's reach so as to make it valid and constitutional. *People v. Globe Grain & Mill. Co.* (1930) 211 Cal. 121, 127. Any interpretation of a statute should dispose of constitutional attack by reading necessary limitations *into* the statute. *See People v. Globe Grain & Mill Co.* (1930) 211 Cal. 121, 127.

In their opposition to the instant writ, Real Parties pointed out that (1) any attempt by California to regulate claims by an out-of-state corporation against its own directors and officers for alleged unlawful trading on a national market would violate the Commerce Clause of the United States Constitution; and (2) any statute that would purport to allow Peregrine, a Delaware corporation that repeatedly represented that its relationship with its directors would be governed by Delaware law, to change position and sue its own directors under California law would violate the Due Process Clause of the United States Constitution. *See* Return at 28-37.

Unfortunately, the Court's opinion is bereft of any discussion of these constitutional issues as they relate to the interpretation of Section 25502.5. There is no indication that the Court construed the statute "in a manner that is consistent with applicable constitutional provisions, seeking to harmonize the Constitution and the statute." *California Housing Finance Agency v. Elliott* (1976) 17 Cal. 3d 575, 594.

Instead, the Court's opinion highlights the constitutional concerns raised by Real Parties in their briefing and at oral argument. Contrary to Petitioner's recent statement to the media—that "California law as it now reads properly would control these transactions, not only the insider trading transactions but the breach of duty allegations," *see* "Peregrine Ruling Is Reversed on Appeal," San Diego Union Tribune, Dec. 6, 2005, available at http://www.signonsandiego.com/uniontrib/20051206/news_1b6peregrine.html—the Court's opinion indicates the opposite is true. The opinion as written now distinguishes between "insider trading" claims assertedly governed by California law and "breach of the fiduciary duty of loyalty" claims assertedly governed by Delaware law. *See* Opinion at 5, 8. Under the opinion as written, Petitioner can now pursue claims against Real Parties under multiple states' laws, even though the claims arise from exactly the same set of facts. Because the Court's opinion allows Petitioner to pursue claims under different states' laws based on the same set of facts, it subjects Real Parties' activities to inconsistent regulation in violation of the Commerce Clause and violates Real Parties' Due Process right to know what standards will govern their actions. *See* Return at 32-33, 36.[2]

There is no readily apparent reason for the Court to sidestep the constitutional issues. If the Court has considered and rejected Real Parties' constitutional arguments, then the Court's analysis should be included in the opinion. *People v. Rojas* (1981) 118 Cal. App. 3d 278, 288-89 (constitutional

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[2] If Petitioner is correct in proclaiming to the media that the Court has now replaced Delaware law with California law as the rule of decision for breach of fiduciary duty claims, the opinion runs even further afoul of the Commerce Clause. The opinion would then "intrude into the domain of other states that have a superior claim to regulate the same subject matter" in violation of the U.S. Constitution. *See VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1114 (Del. 2005).

requirement (Cal. Const., Art. IV, §14) of a written decision "with reasons stated" is "designed to insure that the reviewing court gives careful thought and consideration to the case and that the statement of reasons indicate that [parties'] contentions have been reviewed and consciously, as distinguished from inadvertently, rejected"). If, on the other hand, the Court has overlooked the issues, then rehearing would clearly be warranted. *San Francisco v. Pacific Bank*, 89 Cal. at 25.

* * * *

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APPENDIX K

IN THE SUPREME COURT
OF THE STATE OF CALIFORNIA

Supreme Court No. __
4th Civil No. D046348

ROBERT C. FRIESE, as Trustee,
Petitioner,

v.

THE SUPERIOR COURT OF SAN DIEGO COUNTY,
Respondent,

JOHN J. MOORES *et al.*,
Real Parties in Interest.

San Diego Superior Court Case No. GIC 788659
April 1, 2005 Order of the Hon. Joan M. Lewis

Petition for Review of Real Parties in Interest
John J. Moores, Charles E. Noell, III, Norris van den Berg,
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* * * *

IV.

REVIEW SHOULD BE GRANTED TO AVOID THE SERIOUS FEDERAL CONSTITUTIONAL QUESTIONS RAISED BY THE COURT OF APPEAL'S EXTENSION OF CALIFORNIA LAW TO THE INTERNAL AFFAIRS OF A DELAWARE CORPORATION.

The Court of Appeal's application of Section 25502.5 to a foreign corporation's fiduciary duty claims against its own directors and officers raises serious questions under the federal Commerce Clause and Due Process Clause. As explained above in Part I, these serious questions may be avoided by a statutory construction that holds such claims to be matters of internal affairs governed by the law of the state of incorporation. The need to avoid possible federal constitutional violations presents an additional reason why this case raises such important legal questions warranting this Court's review. *See Dyna-Med, Inc. v. Fair Employment & Housing Comm'n* (1987) 43 Cal. 3d 1379, 1387 ("A statute should be construed whenever possible so as to preserve its constitutionality.").

First, the Court of Appeal's decision allows Section 25502.5(a) to govern claims by an out-of-state corporation against its own directors and officers, who may not be California residents, for trading shares on a national exchange as long as the offer to trade "originated" from California. *See Opinion* at A5, A14-A15; Cal. Corp. Code § 25008 (defining purchase or sale of a security). Such regulation of purchase and sale transactions across state lines raises a serious issue of possible direct burden on interstate commerce in violation of the Commerce Clause. *See Edgar v. MITE Corp.*, 457 U.S. 624, 640 (1982) (holding that an Illinois law regulating tender

offers of target companies operating in Illinois violated the Commerce Clause because the tender offer is communicated through means of interstate commerce and the takeover is an interstate transaction). Serious Commerce Clause questions are likewise raised by the Court of Appeal's decision that a California statute regulating board quorum and voting requirements and other internal affairs may be applied extraterritorially to foreign corporations. *See supra* Section III.B; *VantagePoint*, 871 A.2d at 1113 ("[A] state 'has no interest in regulating the internal affairs of foreign corporations.'") (quoting *Edgar*, 457 U.S. at 645-46); *see also CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 93 (1987) ("[A state] has no interest in protecting nonresident shareholders *of nonresident corporations*.") (emphasis in original).

Second, application of Section 25502.5 to foreign corporations raises serious constitutional questions under the federal Due Process Clause. Peregrine chose to incorporate in Delaware and to adopt Delaware law as the law governing the internal affairs of the corporation, including the liability of directors and officers to the corporation. To induce Real Parties to serve as directors, Peregrine represented in its director indemnification agreements, Certificate of Incorporation, by-laws, and public filings that any liability they might have to the corporation would be governed by Delaware law. *See* Ex. 7-E at 285-94; Ex. 7-D at 274; Ex. 7-N at 443. In applying California law to the directors' and officers' duties to their own corporation, the Court of Appeal's decision defeats these legitimate expectations, in violation of the Due Process Clause. *See VantagePoint*, 871 A.2d at 1113; *see also State Farm*, 114 Cal. App. 4th at 444.

The Court of Appeal failed to address these serious issues under the Commerce and Due Process Clauses of the United States Constitution. This omission makes review by this Court of the statutory construction questions here all the more appropriate and important. And unless reviewed and cor-

rected by this Court, the Court of Appeal's interpretation of Corporations Code Section 25502.5 will itself be subject to federal constitutional challenge.

* * * *

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